The Impact of the Supreme Court on Banking Deregulation

Undergraduate Research Thesis

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By

Zachary Lippman

The Ohio State University

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Project Advisor: Lawrence Baum, Department of Political Science

Thesis Outline Draft

Abstract

In my thesis, I assess whether the Supreme Court can impact the actions and policies of regulatory agencies. Specifically, I review the impact that the Burger Court, the Court under Chief Justice Warren Burger, had on regulatory agencies as they deregulated banking policies. I provide three case studies dealing with different deregulatory banking trends that occurred during the Burger Court: the raising of interest rate caps on bank loans, the geographic expansion of banking, and the repeal of Glass-Steagall. For each case, I conduct an in-depth analysis on a survey of Burger Court decisions dealing with the deregulatory trend. Following, I trace the impact of these cases through subsequent agency actions. Through each case study, I find that the Supreme Court provided agencies with deregulatory goals with "regulatory tools" that allowed them to deregulate the banking industry. Similarly, the Supreme Court provided agencies with pro-regulatory goals with "regulatory roadblocks" that hindered their ability to maintain strict regulations over banks. Over time, this allowed the Burger Court to drive banking regulation towards deregulation.

Introduction

Regulatory agencies are tasked with enforcing statutes that are created and passed by the legislature. Federal regulatory agencies enforce statutes passed by Congress and state regulatory agencies enforce statutes passed by their state legislature. Agencies do this in a number of ways. For one, they interpret legislation and turn statutes into specific rules that govern their regulatory population.[1] Statutes will often guide regulators on how to turn their statutes into rules, but regulators are often given broad discretion in their rule making and enforcement of these laws. This broad discretion gives agencies the ability to react to unforeseen developments in their regulatory work.[2] For example, regulatory agencies write rules in response to changes in the industry they regulate in order to update their rules to the new conditions. Though agencies are given broad discretion, they cannot stray too far from the intent and words of the statutes they are given because their rule making is subject to judicial review. [3] If an agency disregards or ignores the language or intent of the statutes handed down to it, its rules can be challenged in court and the agency may have to amend or repeal its rules.

In addition to rule making, regulatory agencies are tasked with rule enforcement. When actors within an industry are not complying with the rules put forward by regulatory agencies, agencies can respond with a variety of actions. In many instances, agencies will take legal action against non-compliant actors within their industry. For example, the Securities and Exchange Commission can file a criminal suit against an investment-banker suspected of insider trading.

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[1] By regulatory population, I refer to the actors that the agencies oversee through their regulation. See Cannon, B.C., & Johnson, C.A. (1999). "Implementing Population" *Judicial Policies. Implementation and Impact* (2nd ed.). Washington, DC: Congressional Quarterly Press

[2] Seidenfeld, M. (2009*).*Why Agencies Act: A Reassessment of the Ossification Critique of Judicial Review." *Ohio State Law Journal,* 70, no*. 2, 251*

[3] Jerry L. Mashaw (1994), Improving the Environment of Agency Rulemaking: An Essay on Management, Games, and Accountability, 57 LAW & CONTEMP. PROBS., 185, 200–04, 229–30

Similarly, the Federal Trade Commission can file a civil suit against a company engaged in monopolistic practices. This rule enforcement work allows regulatory agencies to show their regulatory population that they will be punished if they do not comply with their rules. Ideally, this will drive up the perceived cost of noncompliance to other firms within the industry, and thus, dissuade noncompliance. Because rule enforcement can be dependent on the judicial system, regulators must take into account whether their rules and actions have standing with the courts.[4]

Through rule making and rule enforcing, regulatory agencies play an important role in the United States democracy. They serve as an implementing population by ensuring that the laws established by elected officials are actually employed in practice.[5] Legislatures rely on government agencies to ensure the laws they pass actually have an impact on their constituents. If a regulatory agency decides not to align its rules with statutory law, statutes will have little practical effect. Similarly, if a regulatory agency decides not to enforce its rules, statutes will also have no effect. Further, the way in which the agencies interpret statutes influences how those statutes are carried out and enforced. The importance of regulatory agencies to American democracy makes studying the forces that influence agency decisions important to political science. Knowing what forces impact regulators allows observers to predict how changes in various legal, political, and cultural factors will influence regulatory policy.

While many studies have analyzed various influences of regulatory policy, I focus my research on how the Supreme Court can influence regulatory agencies. I test how the Supreme Court impacts regulatory policy by analyzing the impact the Burger Court had on banking

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[4] Seidenfeld, M. (2009*).*Why Agencies Act: A Reassessment of the Ossification Critique of Judicial Review." *Ohio State Law Journal,* 70, no*. 2, 252*

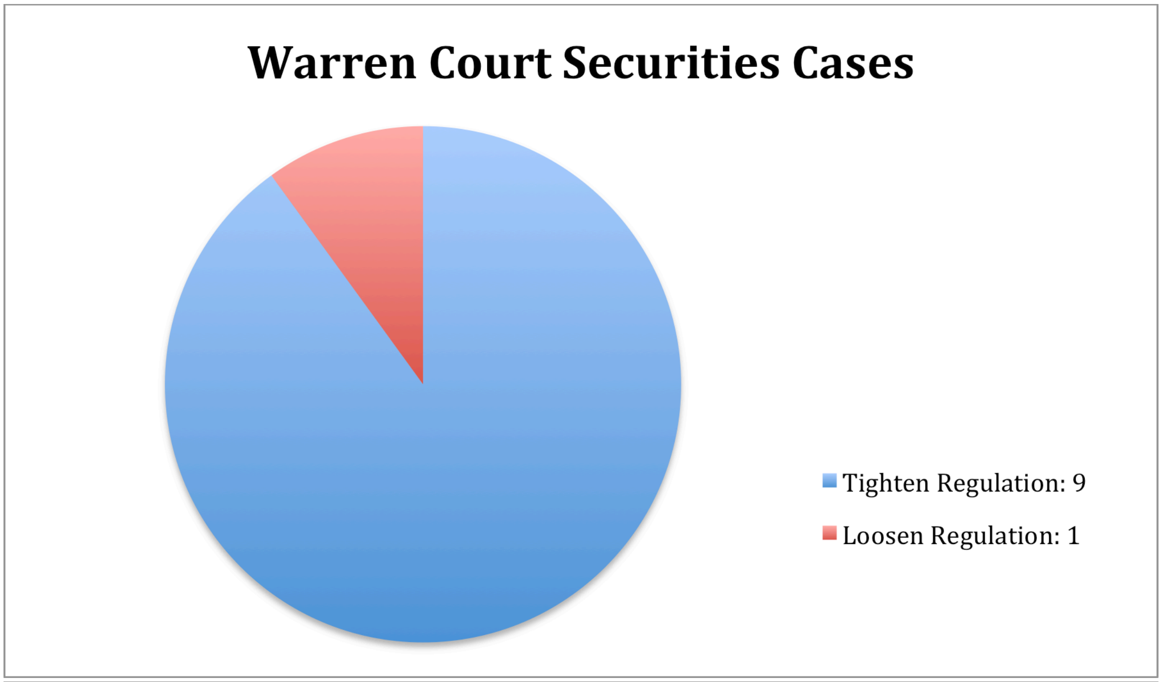
[5] Canon, B.C., & Johnson, C.A. (1999). "Implementing Population" *Judicial Policies. Implementation and Impact* (2nd ed.). Washington, DC: Congressional Quarterly Press

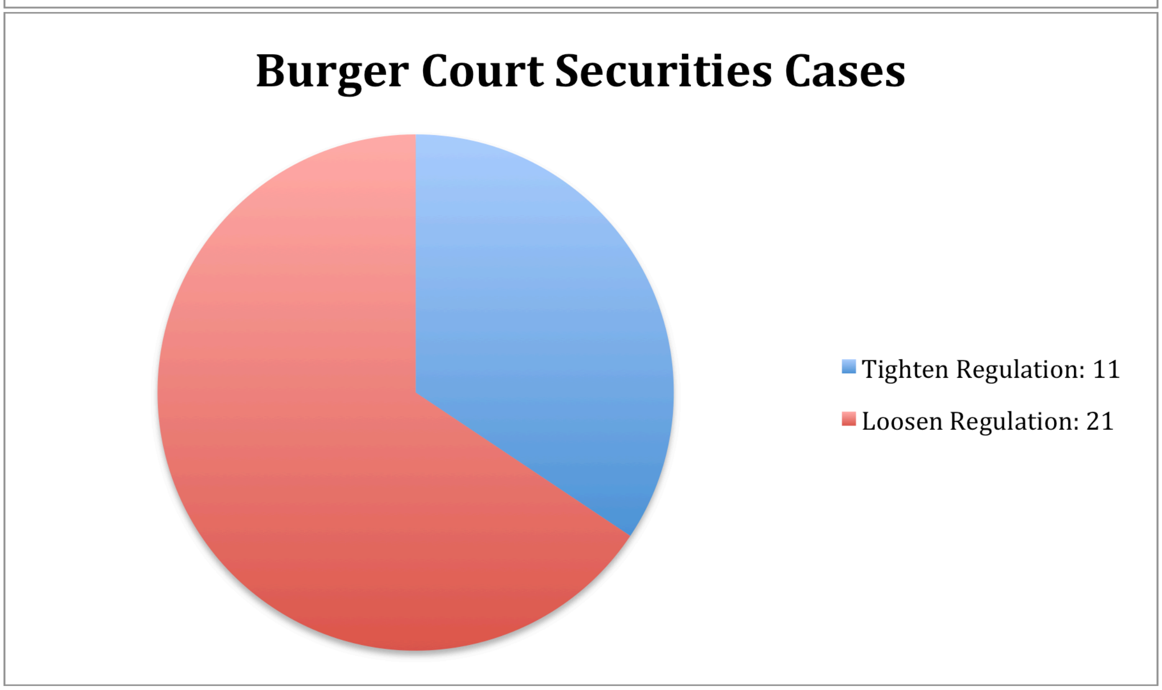
regulation. As can be seen through Figure 1, the Burger Court's banking decisions marked a clear reversal of the previous Court's (the Warren Court) ideological preferences towards securities regulation. "The "Burger Court" refers to the Supreme Court under Chief Justice Warren Burger. This was the Supreme Court from 1969-1986. The "Warren Court" refers to the Supreme Court under Chief Justice Earl Warren. This was the Supreme Court from 1953-1969. This change coincided with a noticeable wave of deregulatory actions by banking regulatory agencies. This correlation prompted me to further investigate what role the Supreme Court played in this deregulation.

Through my analysis, I found that the Supreme Court was able to influence the direction of regulatory policy. Through determining this causal impact, I develop a new theory of the judicial-agency relationship. I argue that the Court can impact government agencies and their regulatory policies by providing "regulatory tools" to agencies whose goals align with Supreme Court decisions. Similarly, I contend the Supreme Court can create "regulatory roadblocks" that inhibit regulators with goals opposing the Supreme Court's decisions. Because agencies have limited resources, agencies with goals that have many roadblocks attached to them will focus their resources on other goals. Similarly, agencies with tools to get around the roadblocks that block a major goal will focus their resources on that goal. In this manner, the Supreme Court helped decide which government agency goals were achieved and which government agency goals were not achieved. In the context of banking deregulation, the Supreme Court limited agencies with pro-regulatory goals and aided agencies with deregulatory goals.

I begin the thesis, in Section 1, by reviewing the relationship of government agencies and the Supreme Court. In this section, I discuss previous theories on the judicial-agency relationship. Following, I describe my own theory and explain how I tested it through my research. In Section 2, I examine the relevant actors that played a role in the deregulation of the banking industry. I outline the economic and banking conditions of the time period. Next, I review the history of the Burger Court and the relevant banking regulatory agencies. In Section 3, 4, and 5, I dive into three "deregulatory trends" that I use as case studies for the Burger Court's impact on banking regulation. I assess the Supreme Court's impact on the deregulation of interest rate caps on bank loans, restrictions on geographic bank expansion, and the repeal of Glass-Steagall. After reviewing each of these case studies, I summarize my conclusions and hypothesize what these findings imply for the future of our understanding of the judicial-agency relationship.

Figure 1: Warren Court Securities and Consumer Protection Laws Cases (left) vs. Burger Court Securities and Consumer Protection Laws Cases





Washington University Law School, The Supreme Court Database, Cases selected: Warren Court and Burger Court; judgments of the Court, opinions of the court, and per curiam (orally argued); federal or state regulation of securities (http://scdb.wustl.edu/analysis.php)

Part 1: Inter-Branch Background

In this section, I provide a comprehensive review of the existing literature analyzing the relationship between the Supreme Court and government agencies. I discuss what motivates agencies to act and what causes agencies to respond to the Supreme Court. Throughout my review of past literature, I show how my research fits in and complements previous studies. Finally, I end this section by offering my own inter-branch framework, which I term the regulatory tool and roadblock framework, and I explain how I prove this theory through my thesis.

A. The Supreme Court and Regulatory Agencies

I. What Causes Agencies to Act?

In order to understand the relationship between the Supreme Court and government agencies, it is important to understand what causes agencies to act. Determining what causes agencies to act involves looking at the motivations of agencies and the individuals who make agencies up. In James Perry and Lois Wise's article, *The Motivation Bases of Public Service,* the authors name three important motivations of the individuals who work for regulatory agencies.[6] Perry's first motivation is the rational motive.[7] Perry and Wise note that each individual actor is driven by his or her utility maximization. Taking action that maximizes his or her own utility motivates a civil servant. In financial regulation, the idea of the "revolving door" plays an important role in this motivation. Often times a regulator's ultimate goal is to work for one of the firms he or she is regulating, and this impedes that regulator's ability to establish tough rules or

[6] Perry, J.L., Wise, L.R. (1990). The Motivational Bases of Public Service. *Public Administrative Review,* 50, No. 3, 367-373.

[7] ibid, at 368.

enforce tough regulations.[8] Thus, a public servant may be rationally motivated to cater to the interests of the actors he or she is supposed to regulate.

Perry and Wise also argue that civil servants are motivated by the social importance of their work and their desire to serve the public interest.[9] According to this motivation, a regulator will be motivated to enact a certain policy because of his or her genuine belief that this policy is beneficial to the public. Though this motivation is less self-interested than the rational motivation, it is still subject to the ideological biases of individual regulators. Regulators with differing ideological backgrounds will have different views on which courses of actions are socially important and beneficial to society. Thus, shifts in the ideological breakdown of an agency can have a significant impact on the actions that agency takes.

Another important way to think about regulatory action is by analyzing the process by which agencies, as a whole, decide to take action. Mark Seidenfeld has developed the "purposive process" to explain how agencies set their agenda.[10] Seidenfeld explains that an agency begins the process of agenda-setting by laying out its goals. Each agency has many goals, and these goals are derived from the mission of an agency, pressure from law makers, and the ideological preferences of the agency's leadership.[11] After laying out the agency's goals, an agency will identify the significant roadblocks that stand in the way of the agency achieving its goals. For example, the Environmental Protection Agency (EPA) might lay out its goal to increase the use of renewable energy over fossil fuels in the United States. Then, the EPA would note that this

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[8] Wilmarth, Arthur E. "Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street." *University of Cincinnati Law Review,* col. 81, 18 Sept. 2013, pp. 1287. *LexisNexis Academic.*
[9] Perry, J.L., Wise, L.R. (1990). The Motivation Bases of Public Service. *Public Administrative Review,* 50, No. 3, 368.
[10] Seidenfeld, M. (2009*).*Why Agencies Act: A Reassessment of the Ossification Critique of Judicial Review." *Ohio State Law Journal,* 70, no. *2, 252-321*
[11] ibid, at 261

goal is currently roadblocked by the high prices of renewable energy sources. After laying out roadblocks standing in the way of major goals, an agency will evaluate the potential solutions that will allow an agency to overcome a roadblock and accomplish their goals. These solutions can come internally from agency staff, or can be derived from an outside force such as a lobbyist, Congress, or the Courts. Because of time and resource constraints, an agency will focus on major goals that have limited roadblocks with easily discernible solutions.[12]

II. What Causes Agencies to Respond to the Court?

If both individual motivations and the purposive method cause agencies to act, the question remains why these forces would cause agencies to respond to the Supreme Court. James Spriggs sought to measure what influenced agencies to comply with Supreme Court decisions. Spriggs' analyzes a series of Supreme Court cases where the Court reversed or remanded an agency action.[13] Spriggs found that agency compliance with the Supreme Court in these cases depended on factors such as the specificity of the opinions, the ideological preferences of the agency, the age of the agency, and the amicus curiae support of the case.[14] Overall, Spriggs theorizes that these factors influence agencies because agencies are likely to comply when the cost of noncompliance is high. While Spriggs theorizes what causes agencies to comply with the Supreme Court, Canon and Johnson seek to understand what causes actors to not comply with the Court.[15] Canon and Johnson offer reasons why government agencies do not implement Supreme Court decisions. Canon and Johnson note that agencies often do not want to comply

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[12] ibid, at 262.
[13] Spriggs, J.F. (1996). The Supreme Court and Federal Administrative Agencies: A Resource-Based Theory and Analysis of Judicial Impact. *American Jounral of Political Science,* 40, 4th ser., 1122-1151
[14] ibid
[15] Canon, B.C., & Johnson, C.A. (1999). "Implementing Population." *Judicial Policies. Implementation and Impact* (2nd ed.). Washington, DC: Congressional Quarterly Press

with the Supreme Court because it could hamper their career aspirations. It is easy to see how the rational motive, discussed by Perry and Wise, can cause an individual regulator to not wish to comply with the Court if that regulator believes implementation will impede his or her career success. A bank examiner for the Federal Reserve who wishes to one day work for a bank may not want to report that bank's noncompliance with a Supreme Court decision. Further, the social importance motivation discussed by Perry and Wise can cause a regulator to not comply with the Supreme Court when a regulator is ideologically opposed to the decision.

Though Spriggs' and Canon and Johnson's studies were enlightening, their results do not measure all Supreme Court responses to court cases. Spriggs only measures agencies' response to the Supreme Court in terms of agencies' compliance. Further, Canon and Johnson measure the court's impact through agency's implementations of its rulings. However, an agency can respond to a Supreme Court case in important ways other than compliance and implementation. For example, in a case analyzed in Part 5 of this thesis, the Supreme Court ruled that the Federal Reserve should be granted "greatest deference" in determining what activities banks can engage in.[16] The Supreme Court affirmed to all lower courts that the Federal Reserve is allowed to stretch its authority in determining what activities it can permit its banks to engage in. As explained in Part 5, the Federal Reserve responded to this decision by expanding the list of permitted activities for its banks. This expansion would not be measured under Spriggs measure of compliance or Canon and Johnson's measure of implementation. In this way, Spriggs and Canon and Johnson leave out of their analysis many cases in which the Supreme Court impacts agencies. Through my research, I expand the understanding of the judicial-agency relationship

[16] *Board of Governors FRS v Investment Company Institute,* 450 U.S. 46 (1981)

by moving past just the use of compliance and implementation as a measure judicial impact on agencies.

B. Regulatory Tool and Roadblock Theory

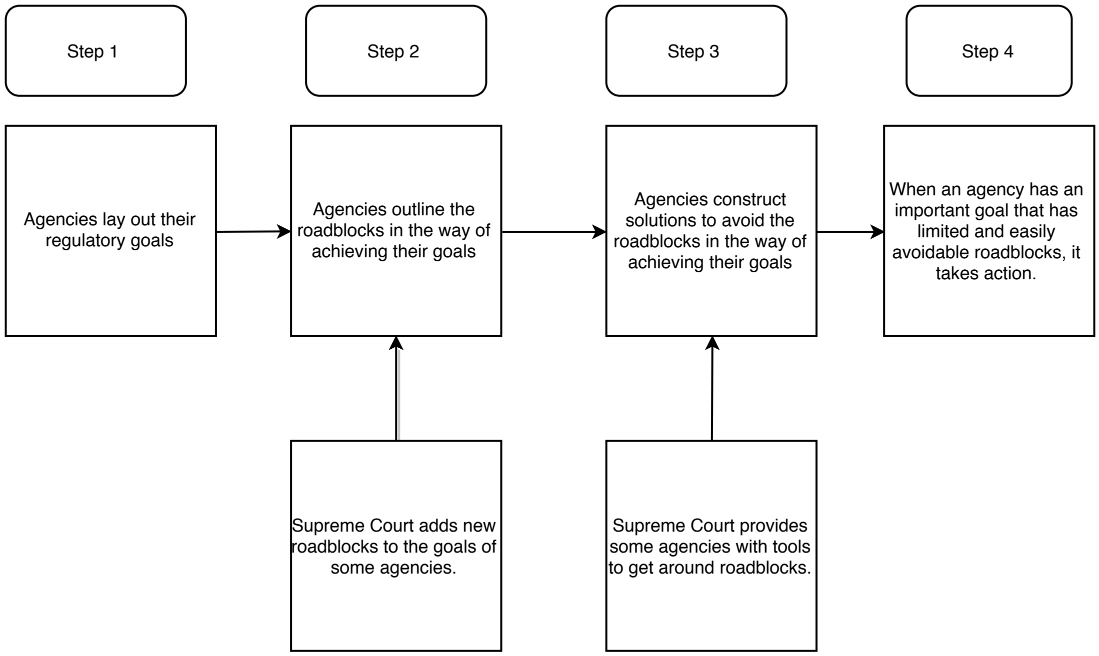
Drawing on the existing literature and the research discussed throughout this thesis, I have developed my own framework to understand the judicial-agency relationship. I refer to this framework as the Regulatory Tool and Roadblock Theory. Regulatory agencies have many goals, and they seek to accomplish these goals through making rules and taking enforcement actions. However, due to constraints, regulators cannot focus on all of their goals. As brought forward through Seidenfeld's purposive process, regulators will chose to take action to achieve a goal when the roadblocks in the way of achieving a goal are limited and have easily discernible solutions.

Through my research, I have observed that the Supreme Court can impact agencies by providing them with the easily discernible solutions they need to work around roadblocks and achieve their goals. I call these solutions, "regulatory tools." As one example, some federal agencies during the Burger Court had goals to remove regulations on banks. However, these agencies were often unable to do so because strict state banking laws, which federal regulators could not control, acted as roadblocks in the way of achieving deregulation. However, in my research, the Supreme Court often times granted federal agencies the ability to override state laws. This ability to override states was a "regulatory tool" that federal agencies could use to get around the roadblock of strict state laws to achieve the goal of banking deregulation. When the Supreme Court provides regulatory tools, it makes it more likely that an agency will be willing and able to achieve some of its goals that previously had too many unavoidable roadblocks to be achieved.

The Court can also impact regulators by adding new roadblocks that prevent agencies from accomplishing goals they had previously been able to achieve. In the previous example, state agencies with goals to keep strict rules on banks were no longer given the ability to counteract federal deregulation with strict state laws. These court decisions, thus, roadblocked state agencies from achieving their goal of maintaining strict controls on banks in their states. As the Supreme Court attached more regulatory roadblocks to the goals of certain agencies, those agencies were forced to focus their resources on more achievable goals. Thus, through providing agencies with regulatory tools and regulatory roadblocks, the Supreme Court helped determine which agency goals would be accomplished and which agency goals would not be. In terms of banking deregulation, this meant that the Supreme Court helped some agencies accomplish their deregulatory goals and road-blocked other agencies from accomplishing their pro-regulatory goals. Over time, this led to an accelerated deregulation of banks by government agencies.

Through my thesis, I seek to prove this regulatory tool and roadblock theory through three case studies involving different deregulatory trends: the easing of interest rate caps, geographic expansion of banking, and the repeal of Glass-Steagall. I spend the next section outlining the economic, political, and administrative conditions that were relevant to the three case studies. Throughout the three case studies, I use a survey of Supreme Court decisions and subsequent agency actions to support the regulatory tool and roadblock theory. When looking at agency responses, I look through available documents from the agency rule-making process for explicit references to the Supreme Court decisions and the regulatory tools and roadblocks established through those decisions. I also look through relevant litigation that agencies engaged in after the Supreme Court decisions to see how these agencies were utilizing their new tools or being hampered by their new roadblocks in court proceedings. Through this process, I provide a justification that my inter-branch theory works to explain the Supreme Court-Agency relationship in banking regulation.

Figure 2: Regulatory Tool and Roadblock theory



Part 2: The Context

In this section, I outline the context that the three case studies presented in Parts 3, 4, and 5 take place in. I begin by reviewing the general economic and banking conditions that persisted throughout the Burger Court. Specifically, I describe how increased inflation and financial innovations pushed commercial banks to pressure their regulators towards deregulation. Following, I discuss the Burger Court and the ideological changes that were brought on through Richard Nixon's nominations. Lastly, I provide a general overview of financial regulatory agencies. I first provide an overview of financial regulators as a whole, and then detail the specific agencies that played an important role in one or more of the three case studies presented in Part 3. Through providing the general context of the three case studies, I lay the foundation for why the actors within the case studies acted in the manner that they did.

A. Economic and Banking Conditions

In the late 1960s and 1970s, the United States experienced an unusually high level of inflation.[17] Inflation, as can be seen through figure 3, remained high throughout this time period. When inflation first began in the 1960s, it occurred at the same time as the United States was experiencing growing unemployment.[18] This troubled economic regulators at the time because classical economic theory had dictated that inflation and unemployment should carry an inverse relationship. Generally, monetary policy setters at the Federal Reserve could curb inflation through increasing interest rates. However, with unemployment also rising, regulators were worried that increasing interest rates would dampen an already bleak economy. It was not until

[17] European Union. "Historic Inflation United States –CPI inflation." *Inlation.EU Worldwide Inflation Data,* European Union, www.inflation.eu/inflation-rates/united-states/historic-inflation/cpi-inflation-united-states.aspx.
[18] Bureau of Labor Force Particiaption. https://data.bls.gov/pdq/SurveyOutputServlet

Figure 3: Inflation and Unemployment in the United States

Inflation 1955-2017

Source: European Union. "Historic Inflation United States –CPI inflation." *Inlation.EU Worldwide Inflation Data,* European Union, www.inflation.eu/inflation-rates/united-states/historic-inflation/cpi-inflation-united-states.aspx.

Unemployment 1955-2017

Source: Bureau of Labor Statistics. https://data.bls.gov/pdq/SurveyOutputServlet

policy setters in the late 1970s, led by Federal Reserve Chairman Paul Volcker, finally decided to raise interest rates at the cost of inducing a recession that inflation was finally able to ease.[19]

1970s inflation had a significant impact on the banking industry. Inflation causes an increase in interest rates as individuals and companies demand more money to meet their needs.

[19] Brandl, Michael W. "Financial Markets Through Time." *Money, Banking, Financial Markets & Institutions,* Cengage Learning, 2017, pp. 77-102

Rising interest rates complicated the profitability of banks because of strict controls by regulators on interest payments. Banks were capped on the interest they could pay depositors by a Great Depression era rule known as Regulation Q. This was good because it prevented the market from driving up interest rates to the point where taking in consumer deposits was no longer profitable for banks. However, at the time, Regulation Q meant that depositors at banks could not reap the benefits of higher interest rates. Because of interest restrictions, competition in the financial market place greatly intensified.[20] Banks began losing depositors to less-regulated money market funds – this process is called disintermediation – which allowed individuals to receive the more generous interest payments than bank accounts. As depositors left banks for money market funds, banks lost a traditionally stable source of revenue.

Eventually, banks lobbied lawmakers to repeal Regulation Q so that they could pay competitive interest rates on their deposits. This ended up being troubling for commercial and thrift banks at the time because they earned their profits through interest rates spreads. Banks pay interest on the deposits that they hold, and they receive interest payments on the loans that they make. It was the spread between the interest payments banks took in and the interest they paid that constituted how profitable that a bank could be during this time period. As banks had to pay higher interest rates on their deposits, this spread was reduced and banks became even less profitable. This was even more troubling because strict usury laws limited banks in many states from collecting high interest rates on their loans. Around this time, banks lobbied Congress and regulators to get rid of the restrictions that limited who they could make loans to and how much interest they could collect on their loans.

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[20] Federal Deposit Insurance Corporation, Division of Research and Statistics. "A Brief History of Deposit Insurance in the United States." Washington D.C., Sept. 1998

As banks were seeing profits dissipate with high inflation, banks began looking for new sources of income other than taking in deposits and making loans. At the same time, securities market innovations were allowing investment banks to boom and earn enviably high profits. The Glass-Steagall Act, a Great-Depression era regulation, prevented commercial banks from engaging in securities related activities such as underwriting and selling securities such as commercial paper. Commercial paper, or unsecured short-term bonds, allowed companies to raise money without taking in loans from banks. Instead of relying on banks to make loans to these companies, these companies relied on investment banks to underwrite these short-term bonds and sell them to investors. Commercial paper transactions became very popular and very profitable for investment companies and took away many loan customers from commercial banks.[21] Additionally, the rise of securitization and collateralized-debt-obligations, such as mortgage backed securities, allowed investment companies to profit off loans in ways that banks were restricted from.[22] As commercial banks continued to lose profits to investment companies, banks began to pressure regulators to repeal Glass-Stegall prohibitions and banks to allow banks to engage in securities activities.

B. The Burger Court

As mentioned in the introduction, the Burger Court marked a noticeable shift in the Supreme Court's stance on banking issues. As can be seen through Figure 1, the Warren Court voted to strengthen regulation roughly 90% of the time. In contrast, the Burger Court voted to strengthen regulation roughly 34.3% of the time.[23] The ideological shift of the Burger Court can

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[21] ibid
[22] ibid
[23] Washington University Law School, The Supreme Court Database, Cases selected: Warren Court and Burger Court; judgments of the Court, opinions of the court, and per curiam (orally

be traced to the addition of four new Justices to the Court from 1969 through 1972. The first appointee was Warren Burger himself, who was nominated by Richard Nixon in 1969. According to Burger's Segal-Cover scores – a measure of a Justice's ideology as perceived by newspaper editorials written during upon their appointment – Burger was perceived as conservative in relation to the rest of the associate justices.[24] In general, conservative justices are more likely to vote to remove regulations and liberal Justices are more likely to vote to strengthen those regulations. The Segall-Cover scores are a good measure to trace because they best capture how regulators and bankers perceived each justice at the time of their nomination.

Following Burger, Richard Nixon nominated Harry Blackmun as an associate Justice to the Court. Blackmun, who was considered very conservative by the Segal-Cover scores, replaced Abe Fortas, who was viewed as liberal.[25] In 1971, Nixon nominated William Rehnquist and Lewis Powell on the same day. Rehnquist was viewed as one of the most conservative Justices on the bench from 1937-2012.[26] Richard Nixon's appointee that most prominently foreshadowed the future direction that the Court would take with regards to banking regulation was former securities attorney Powell. Powell, who was viewed by the Segal-Cover score as conservative, was a notable activist for free enterprise and against government intervention in free markets.[27] Powell gave various speeches warning about the dangers of communism and the spread of

argued); federal or state regulation of securities and federal or state consumer protection issue areas (http://scdb.wustl.edu/analysis.php)

[24] Segal, Jeffrey A; Epstein, Lee; Cameron, Charles M; and Spaeth Harold J. "Ideological values and the Votes of U.S. Supreme Court Justices Revisited," *Journal of Politics.* August, 1995, p. 816

[25] ibid

[26] ibid

[27] ibid

socialist ideals on college campuses.[28] Powell seemed to be compulsively worried that students were not being adequately educated of the dangers about communism. Further, Powell was paranoid that communism was brewing in the United States on college campuses via college professors. Just one year before his election to the Supreme Court, Powell wrote a confidential memo to the chairman of the United States Chamber of Commerce where he urged American businesses to engage in a war-like counter-attack on regulation. Powell argues the "American economic system is under broad attack" by "New Lefties and other revolutionaries."[29] Powell followed that American systems need to fight back these "new lefties" through direct political action and policy changes. It is unsurprising that, as soon as Powell was in a position where he could impact regulatory policies, he began pushing for deregulation. By packing the Court with four new conservative faces, especially with Powell and his intentions of war against regulations, Richard Nixon allowed the Court to give way to deregulatory pressure.

C. The Regulators

Banking regulatory agencies, like all agencies, are tasked with ensuring that the laws Congress passes to regulate the banking industry are enforced in practice. They do this by taking the broad statutes that Congress enacts and turning them into specific rules banks must follow. Further, bank regulators are tasked with continuously looking back and ensuring their rules are up to date with current banking conditions and innovations. In these ways, banking regulatory agencies are similar to all government agencies. However, there are important differences between financial regulatory agencies and other agencies. Gillam Metzger has established four

[28] Powell, Lewis. "What Should our Students Know?" Chicago, April 26, 1960. National School Boards Association Meeting. Notes on Pannel Program. Law2.wlu.edu/powellarchives/.
[29] Powell, Lewis F. "Attack on American Free Enterprise System." Received by Eugene B. Sydnor, Jr., 23 Aug. 1971, *law2.WLU.edu*, Washington and Lee School of Law.

main differences between financial regulators and other regulators.[30] The first difference he describes is administrative structure and institutional design. In general, banking regulators, especially the Federal Reserve, are supposed to act rather autonomously from the government. For example, the Federal Reserve possesses budgetary autonomy, the freedom from the White House oversight, and norms of noninterference. In contrast, most other government agencies lack independence from either their executive or legislative supervisory body. This allows banking regulatory agencies to focus on goals that they believe are important to their industry rather than focusing on short-term political goals.

A second difference between banking regulatory agencies and other agencies is their relationship with other regulators.[31] Banking regulators are often forced to compete with state regulators over their joint characteristics. For example, the Office of the Comptroller of the Currency (OCC) must compete for bank charters with state banks. The OCC generates its revenue by approving bank charters; however, a bank can chose to get its charter through a state regulator or through the OCC. In contrast, other agencies often enjoy a cooperative relationship with other regulators. This competitive relationship between state and national bank regulators creates deregulatory pressures as both state and federal banks are incentivized to decrease the strictness of their rules to attract "regulatory clients." This issue is discussed more extensively later in this section.

A third difference between banking regulatory agencies and other agencies is the role the market plays.[32] According to Metzger, the goal of banking regulation is often to allow free

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[30] Metzger, G.E., (2015). "Through the Looking Glass to a Shared Reflection: The Evolving Relation-ship Between Administrative Law and Financial Regulation. *Law and Contemporary Problems* 78, 129-156
[31] ibid
[32] ibid

markets to function. This is in contrast to other regulatory agencies, which view the market as something that needs to be restrained. As an example, Metzger points to the Environmental Protection Agency (EPA). The EPA views the market as a force that, uncontrolled, will lead to health and safety issues. Thus, the EPA seeks to write rules that constrain the free market from operating in a natural manner. The perceived difference in the role of the market in regulation adjusts the ultimate goals of banking agencies and other agencies. For banking agencies, because the ultimate goal is to allow free markets to operate efficiently and effectively, deregulation is considered a legitimate and effective policy solution.

Rather than being regulated by one agency with broad authority over all banks, banks are regulated by a web of regulators who oversee different types of banks and different functions of banks. In this way, the multiple banking regulators each have unique goals and jurisdictions that allow them to exert varying influence over bank regulatory policies. For the rest of this section, I provide a brief overview of the relevant banking regulatory agencies that played a role in the three case studies presented in the thesis.

I. The Office of the Comptroller of the Currency (OCC)

The OCC was created during the Civil War as a means to establish a national banking system that could help finance the North's war efforts. The OCC was given the authority to charter, or give permission to establish, all national commercial banks. Commercial banks are banks that take in deposits and make most of their loans to businesses. To this day, each national bank must receive a charter from the OCC in order to operate. The OCC writes rules that banks must comply with in order to keep their charter. It also is in charge of supervising banks to ensure they are continuing to comply with their rules. Further, the OCC must approve geographic bank expansions. Because of these functions, the OCC acts as the chief regulator for national commercial banks. The OCC is an agency within the Treasury Department, meaning that it is housed within the executive branch. Because of this, the President appoints the head of the agency, which is known as the Comptroller of the Currency. This means that the OCC often derives its goals from the current administration. According to its mission, the OCC uses its regulatory powers to ensure banks "operate in safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with laws and regulation."[33]

Despite this broad mission statement, the OCC has a powerful incentive to cater to the interests of the banks it regulates. The OCC receives its funding through fees from the banks it regulates. When a bank is seeking a charter, it has the ability to obtain one from the OCC or from a state comptroller of currency. Further, before the 2008 financial crisis, a bank could obtain a charter as a national bank from the OCC or as a national thrift from the Office of Thrift Supervision. Former Secretary of Treasury Tim Geithner explains that this gluttony of agencies with overlapping chartering jurisdictions fosters "regulatory arbitrage."[34] The OCC must cater to the interests of its regulatory clients or it will risk losing the clients and thus their funding. According to former Federal Reserve Chairman Ben Bernanke, the "OCC at times actively sought to induce banks to switch to a national bank charter."[35] Throughout the three case studies presented in Part 3, the OCC consistently advocates on behalf of their regulatory clients in their pursuit to remove regulations on national bank activities.

II. Federal Home Loan Bank Board (FHLBB), Federal Housing Finance Board (FHFB), and the Office of Thrift Supervision (OTS)

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[33] "About the OCC." *OCC,* U.S. Department of Treasury, www.occ.treas.gov/about/what-we-do/mission/index-about.html.
[34] Geithner, T.F. (2014). *Stress Test.* New York, New York; Crown. p 97.
[35] Bernanke, Ben (2015). *The Courage to Act.* W.W. Norton & Company, p 96.

The Federal Home Loan Bank Board was established during the Great Depression to regulate the activities of thrift institutions. Thrift institutions, also called Savings and Loans, are banks that take in deposits and mainly use them to make mortgage loans to homebuyers. After the Savings and Loans Crisis in the 1980s, the Federal Home Loan Bank Board relinquished its responsibilities to two superseding agencies: The FHFB and the OTS. The FHFB and OTS were both dissolved after the 2008 financial crisis due to their negligent regulation of thrifts.

During the 1970s, thrift institutions' profits suffered because of high inflation and high interest rates. In 1979, interest rates were over 13%, but thrifts could not pay their depositors more than 5.5%.[36] Further, thrifts were no longer making sufficient profits making low return housing loans, so they sought to make high return loans in other sectors of the economy. In the early 1980s, thrifts pressured the FHLBB to remove many of the restrictions that limited what kind of loans thrifts could make. Also at the time, the thrift regulator consistently sought to exempt its regulatory clients from many state and local regulations to ensure thrifts chartered nationally instead of through their respective states.[37] According to Ben Bernanke, he saw thrift regulators were "focused too much on preserving a regulatory client and not enough on the broader risks to the system."[38] This led to many thrifts taking on too much risk that, in large part, led to the Savings and Loans Crisis of the 1980s. After the FHLBB dissolved, its superseding agencies became "notoriously weak" supervisors.[39] Throughout the three case studies, thrift regulators consistently used Supreme Court decisions to justify the removal of regulations on thrifts.

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[36] Pizzo, Stephen, et al. *Inside Job: the Looting of Americas Savings and Loans.* HarperPerennial, 1991. p 4.
[37] Bernanke, Ben (2015). *The Courage to Act.* W.W. Norton & Company, p 96.
[38] ibid
[39] Geithner, Tim (2014). *Stress Test.* New York, New York; Crown. p 97.

III. Federal Deposit Insurance Corporation (FDIC)

The FDIC was created during the Great Depression to help stabilize the banking sector in a time of crisis and prevent further "bank runs" and bank failures. Before the FDIC existed, if a depositor was worried that its bank was at risk of failing, depositors would come to the bank and demand that they get their money back before the bank would fail. Thus, a bank already at risk of failing is even more likely to fail as depositors withdraw the limited reserves the bank keeps on hand – this is called a bank run. Because of asymmetric information, these bank runs often become contagious. Depositors remain unaware of how a bank is spending their deposits, so if depositors see one bank is failing, they are unaware how likely their bank is to fail as well. This causes bank runs to spread to healthy and safe banks, and thus puts the entire banking system at risk. The FDIC was established to ensure depositors that if their bank does fail, the FDIC would pay the depositor up to a certain amount of deposits that they had held at the bank.

The FDIC has two main roles: to insure depositors and to resolve failed banks. The FDIC plays a regulatory role by establishing rules that members of the fund must follow in order to be insured.[40] The FDIC also must approve any bank mergers or acquisitions for any insured bank. In order to build the fund to insure deposits, the FDIC takes in fees from insured banks. Congress does not appropriate any money to the FDIC, so unless a specific statute refills the fund with taxpayer money, the fund is made up entirely of fees from the institutions the fund regulates. In the 1980s, the thrift deposit insurance fund went bankrupt after failed thrifts needed $60 billion to pay out depositors in the wave of failed savings and loans.[41] After the thrift deposit insurance went bankrupt, the FDIC saw the importance of both providing a safe overall banking system

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[40] "Federal Deposit Insurance Corporation." FDIC: Who is the FDIC?, *Department of Treasury,* www.fdic.gov/about/earn/symbol/.
[41] Pizzo, Stephen, et al. *Inside Job: the Looting of Americas Savings and Loans.* HarperPerennial, 1991.. p 4.

and having a large enough fund to cover large losses. In order to maintain a sizable insurance fund, Congress changed the mandate of the FDIC in 1991 to require that they resolve failing firms “at the lowest possible cost to the deposit insurance fund.”[42] Because of this, the FDIC had to focus its banking supervision on ensuring that their fund was not at risk. According to Ben Bernanke, the FDIC was “tenacious about protecting the deposit fund,” but that sometimes this meant the FDIC put the interests of the fund “ahead of the interests of the broader financial system.”[43] In terms of deregulation, it was important that the FDIC maintained bank profitability, because lack of profits could lead to bank failures, and bank failures would put the fund at risk. Thus, in the face of inflation and increased competition from investment companies, the FDIC promoted deregulation as a means to maintain bank profitability and stave off bank failures.

IV. The Federal Reserve (the Fed)

The Federal Reserve, which was established in the wake of the 1907 banking crisis, has many functions in the banking system. The Federal Reserve holds reserves for its member banks, meaning that it serves as a bank for banks. Importantly, the Federal Reserve establishes the monetary policy that determines the money supply and the interest rates in the economy. The Federal Reserve also acts as a lender of last resort during financial crises to ensure that troubled banks do to not fail. While these roles are important, in this thesis, I focus on the Federal Reserve in its role as a bank supervisor. After the Bank Holding Company Act of 1956, all Bank Holding Companies were required to register with the Federal Reserve and comply with its rules.[44] In this way, the Federal Reserve acts as the chief regulator for bank holding companies. Bank holding companies are companies that own banks. Further, all banks that are members of the Federal

[42] Bernanke, Ben (2015). *The Courage to Act.* W.W. Norton & Company
[43] ibid
[44] Bank Holding Company Act of 1956, 84th Congress, (1956)

Reserve System are bound to the rules of the Federal Reserve. The Federal Reserve Board has the ultimate responsibility for bank supervision within the Fed.[45] The board must approve mergers and acquisitions by bank holding companies and member banks. This is important because, in the time period of the three case studies, bank holding companies were restricted from purchasing many types of non-bank companies. The Federal Reserve had the ultimate say in what type of companies bank holding companies were able to purchase.

Because the Federal Reserve Board has the ultimate say over bank regulation, the Federal Reserve Chairman has significant discretion over the direction the Fed takes banking regulation. The President appoints the Federal Reserve chairman for four-year terms. From 1970 to 1978, the Federal Reserve Chairman was Arthur Burns. Richard Nixon, a staunch opponent of government interference in free markets, nominated Burns. Paul Volcker followed Burns. Volcker served at a time with very high inflation, and his major goal was to combat inflation and its harmful effects. The final relevant Federal Reserve Chairman to my research was Alan Greenspan. Greenspan, a protégé of Ayn Rand – the notable laissez fairre capitalist – was a vocal proponent of deregulation. Greenspan also maintained a very close relationship with banks and investment companies, and was supportive of the integration of the banks and investment banks.[46] Throughout Part 5, Greenspan's Federal Reserve used tools granted to the Fed by the Burger Court to meet his deregulatory goals.

In addition to the OCC, the OTS, the FDIC, and the Federal Reserve, many other agencies play a role in the regulation of banks. The Antitrust Division of the Department of Justice enforces antitrust laws and oversees bank mergers and bank expansions. The SEC

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[45] Bernanke, Ben (2015). *The Courage to Act.* W.W. Norton & Company
[46] Lowestein, Roger. *When genius failed: the rise and fall of long term capital management; how one small bank created a trillion dollar hole.* Fourth Estate, 104

monitors the securities activities of financial institutions and works to protect consumers from harmful securities transactions. The abundance of bank regulatory agencies creates a web of regulators that oversees banking activity.

Figure 4: Banking Regulator Chart

Bank Regulator	**Role**	**Policy Goals**	**Implications for Banking Deregulation**
Office of the Comptroller of Currency	Regulator to national commercial banks. Sets standards all its member banks must adhere to.	Due to its reliance on regulatory fees, seeks to induce state banks and national thrifts to switch to national commercial charters to increase its regulatory clients.	Staunch advocate for policies that would increase the profitability of national banks.
Federal Home Loans Banking Board, Federal Housing Financing Board, Office of Thrift Supervision (All Defunct)	Regulator to national thrifts and thrift holding companies. Sets standards all chartered thrifts must adhere too.	Due to its reliance on regulatory fees, seeks to induce state banks, state thrifts, and national banks to re-charter as national thrifts.	Staunch advocate for policies that would increase the profitability of national thrifts.
Federal Deposit Insurance Corporation	Insures the deposits of state and national commercial banks and resolves failing banks.	Insures depositors in federally insured banks in order to ensure confidence in the banking system and prevent bank failures.	After the insolvency of the thrift insurance fund, the FDIC's was obliged to resolve failing firms "at the lowest possible cost to the deposit insurance fund." Wanted banks to remain profitable, even if that meant deregulation, in order to reduce bank failures.

Federal Reserve	In addition to its role in monetary policy, the Fed is responsible for state and federal bank holding companies. The Board is responsible for the supervision and the Reserve Banks are responsible for enforcement.	Because bank regulation is only one aspect of the Federal Reserve's roles, regulatory policy goals can be different based on who are the Federal Reserve chairman and their board.	Chairman Volcker and, especially, Chairman Greenspan oversaw drastic rule alterations leading to deregulation.
Antitrust Division	Enforces antitrust legislation to promote economic competition.	Ensures that market shares of individual banks in certain geographic markets do not become monopolistic. Further, ensure that banks are not engaging in trust-like interest rate setting.	Opposed deregulation in horizontal expansion due to its anti-competitive effects.
Securities and Exchange Committee	Monitors investment banks and securities activities to protect investors	Ensures that investors are investing and trading in a fair and transparent market place.	Equipped to focus on investor protections without a significant concern for structural changes in the banking industry.

Part 3: Case Study 1 – Interest Rate Caps on Bank and Thrift Loans

The first case study looks at the impact that the Supreme Court had on regulators as they removed laws capping the interest rates banks could collect on their loans. Usury restrictions, laws limiting the amount of interest lenders can collect, have ancient roots. Greek Philosopher Aristotle believed, "money ought not to 'give birth' to more money."[47] Ancient Romans developed a theory that, because money was barren, the taking of interest was unnatural, and

[47] Piketty, Thomas, and Goldhammer, Arthur. *Capital in the Twenty-First Century.* The Belknap Press of Harvard University Press, 2017. P. 530.

therefor should be forbidden.[48] Usury restrictions are specifically mentioned in both the bible and the Quran. The Old Testament prohibits interest taking from one Jew to another Jew, but not between a Jew and a non-Jew. The New Testament bans all interest taking, and the Koran bans all excessive interest taking.[49] During the enlightenment period, non-religious arguments to impose strict usury restrictions grew in importance. English merchants pointed to Holland's economic success under strict interest rates as evidence that usury restrictions lead to prosperous economic conditions.[50] Further, Adam Smith wrote that strict usury restrictions would ensure that money would not be lent to those who are most likely to engage in economically destructive activities.[51]

Throughout early modern and colonial times, societies had to balance their religious and moral doctrines banning interest with the commercial needs of credit for their economy.[52] The need for credit pushed Protestant Reformation movements to take away usury restrictions as a religious doctrine. Throughout the Enlightenment Period, many scholars began to observe the negative effects of strict usury laws. Usury limits prevented mutually beneficial trade among informed and consenting adults. Further, usury limits force desperate borrowers into the hands of often times violent "black market" lenders. In the Colonial era in the United States, usury restrictions were as strict as 6% in states like Massachusetts. However, westward expansion after the Revolution made usury laws less strict, as borrowers were willing to pay a high premium for the abundant fertile land.[53] However, once the Civil War brought economic trouble onto the

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[48] Rockoff, Hugh. "Prodigals and Projecture: An Economic History of Usury Laws in the United States from Colonial Times to 1900." *Journal of Economic Literature,* May 2003. *Worldcat,* p. 1.
[49] Ibid, at 1.
[50] ibid, at 7.
[51] ibid, at 8.
[52] ibid, at 6.
[53] Ibid, at 19.

United States, Congress passed the National Currency Act of 1863, which imposed stricter usury laws on lenders.[54] In 1864, this act was amended to limit national banks to charge the interest rate that was allowed in the states that the bank was located. This gave the states considerable power in determining what banks could charge borrowers on their loans.[55]

Up until the Burger Court, there was considerable variation in the interest a borrower could be charged on his or her loans. Because inter-state banking was scarce, the location where an individual or company took out a loan determined what the maximum interest rate that bank could charge was. After high inflation forced regulators to get rid of restrictions on the interest banks could pay on deposits, banks were being forced by market pressure to pay higher interest on their deposits. In states with strict usury laws, the spread between the interest banks were making on their loans and paying on their deposits was being squeezed to the point of unprofitability. Throughout the 1970s, banks looked for ways to get around these strict state usury restrictions.

A. *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp* (1978)

One bank that sought to get around strict usury restrictions was First of Omaha Bank. First of Omaha Bank was located in Nebraska, which had notoriously loose usury laws.[56] First of Omaha Service Corporation, a company owned by First of Omaha Bank, began to advertise First of Omaha Bank's credit card in states outside of Nebraska. First of Omaha sought to "export" Nebraska's interest rates to other states by advertising its bank's credit cards to states with strict usury laws. Section 85 of the National Banking Act dictates that national banks are subject to the

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54 National Banking Act of 1863. Thirty-Seventh Congress. Session III, Chapter 56, 58. 25 Feb. 1863

55 Rockoff, Hugh. "Prodigals and Projecture: An Economic History of Usury Laws in the United States from Colonial Times to 1900." *Journal of Economic Literature,* Mary 2003. *Worldcat, 36*

56 When I say "loose" usury laws, I mean laws that allow for high interest rates on loans.

interest rate limits by the state they are “located” in.[57] When a consumer used his or her First of Omaha credit card, no matter what state the consumer was in, the actual payment of his or her transaction would take place in Nebraska. Thus, First of Omaha's credit card could charge the highest allowable rate under Nebraska’s law; even if this rate was considered usurious, meaning above the allowable limit, in the state the transaction took place.[58]

Many states were upset that First of Omaha was advertising its credit card to borrowers in their states. Because First of Omaha could make high profits on interest from delinquent credit card accounts, the bank could offer lower fees on its credit cards. This gave First of Omaha Bank a competitive advantage in the credit card market against banks located in states with high interest rates. Because the Nebraska usury laws allowed for an 18% interest rate cap, the Omaha credit card subjected its user's unpaid balances to that rate.[59] National Banks headquartered in Minnesota, such as Marquette National Bank, could only obtain 12% interest rates on the unpaid balances on the credit they extended because of Minnesota law.[60] This disadvantaged Marquette and other national banks located in Minnesota because they could not afford to offer low or no fee credit cards. In *Marquette*, Marquette National Bank and the state of Minnesota challenged whether First of Omaha was allowed to "export interest rates" under Section 85 of the National Banking Act.[61]

The question presented to the Supreme Court in *Marquette* was whether Section 85 of the National Banking Act "authorized national banks based in one state to charge its out-of-state

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[57] 12 U.S. Code 85 (1933)
[58] Oral Argument, *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299 (1978), cited in Oyez, p.9
[59] ibid, at 10
[60] *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299, 306 (1978)
[61] Oral Argument, *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299 (1978), cited in Oyez, p.3

credit-card customers an interest rate on unpaid balance allowed by its home state."[62] Marquette argued that a national bank could not export interest rates because this would conflict with the Congressional policy of competitive equality of state and national banks. Allowing banks to export interest rates would allow national banks, who have the ability to move headquarters, to move to states with high interest rates. This would allow national banks to have a competitive advantage over state banks in states with high usury laws.[63] Further, Marquette National Bank argued that allowing a national bank to export interest rates goes against the plain meaning of Section 85 of the National Banking Act because the credit is extended to outside the state.[64] In addition to Marquette National Bank, the State of Minnesota joined the case and argued that allowing other states to export interest rates inhibits Minnesota's ability to protect its citizens from usury.[65]

Omaha First National pointed out that Section 85 allows national banks to charge interest rate on their loans equal to the state in which the bank is located. Further, although a customer might use Omaha's credit card outside of Nebraska, all of the card's banking transactions were conducted in Nebraska. The credit card applications, the sending and receiving of payments, and the actual extension of credit all took place in Nebraska. Omaha First National argued that Minnesota's State Law 48 155, which restricted interest rates that borrowers in the state could be

[62] *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299, 301 (1978)
[63] Oral Argument, *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299 (1978), cited in Oyez, p.18
[64] *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299, Brief for Marquette National abnk, Table of Contents (1978)
[65] *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299, Brief for Minnesota, Table of Contents (1978)

charged on loans, was preempted by Section 85 and did not apply to credit that was extended in Nebraska.[66]

The Supreme Court had to first decide whether federal law preempted state law with regard to interest rate limits. Minnesota law explicitly said borrowers in the state could not be charged interest rates higher than the state maximum. If the court decided that state interest rate maximums had to be respected, then a bank in Nebraska would not be able to export its interest rates to Minnesota because its borrowers were subject to Minnesota's interest rate limits. If the court decided that federal law does preempt state interest rate maximums, then the Court would have to decide if the preemption of Section 85 of the National Banking Act over state interest rate maximums would allow banks in states with loose interest rate caps to export their interest rates to other states. The Supreme Court unanimously affirmed that federal law did preempt state interest rate maximums.[67] Further, the Court affirmed the preemption of Section 85 allows national banks to export their state's interest rate maximums. Because Omaha National Bank conducted its activities in Nebraska, its credit card transactions were located in Nebraska and the bank could use Nebraska's maximum interest rate.[68] Though the court admitted this does limits the ability of states to protect their citizens from usury, the Supreme Court argued that this was never the intention of Congress.[69]

B. *Regulatory Response*

The ability of federal regulators to preempt state usury laws, which was established in *Marquette,* paved the way for two important regulatory movements. First, it established a

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[66] *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299, Brief for Respondent, Table of Contents (1978)
[67] *Marquette (*1978)*,* at 299
[68] ibid, at 306
[69] ibid, at 299

regulatory tool of preemption for national regulators with goals of removing restrictions on banks. Regulators like the OCC and FHLBB, who sought to appease their regulatory clients whose profits were being crushed by rising interest rates, used this preemption tool to override strict state interest rate maximums. Second, it imposed a regulatory roadblock of federal preemption on state regulators who wanted to maintain strict usury laws. State regulators, who previously had the ability to control interest rate maximums, now were at the whim of federal regulators. Even worse for state regulators pushing for strict usury laws, national banks began to leave their states and flock to states with the highest interest rate caps so they could reap the benefits of higher interest rates. This further hurt states with strict usury laws as they saw national banks leave their state.

I. Office of the Comptroller of the Currency (OCC)

At the time of *Marquette*, the OCC was trying to appease its regulatory clients by pushing for looser interest rate maximums. Bank profits were being restricted by strict usury laws, and many argued that these usury laws were restricting available credit in many states.[70] The OCC was quick to use the preemptive powers that *Marquette* gave the federal agency over state regulators in order to help its national banks circumvent strict state usury laws. In October 1979, speaking at a Senate hearing for a bill to preempt state interest rate restrictions on certain loans, Comptroller of the Currency John Heimann used the Supreme Court case to urge Congress to pass the bill. Heimann pointed to *Marquette* in affirming that Congress had the authority to

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[70] *Current Economic Comment by District.* 1974, p. 29, www.federalreserve.gov/monetarypolicy/files/fomc19740515.pdf

override state laws.[71] Heimann argued that "laboring under this weight of this expanding body of case law" it is clear that interest rate caps are becoming obsolete. Heimann used *Marquette* and its preemptive powers to convince the Senate to override state laws. Heimann was ultimately successful in this lobbying, because Congress used its federal preemptive powers many times to override strict state laws.[72]

In addition to just lobbying efforts on the behalf of the OCC, the OCC also used *Marquette* to justify its own rule-making with regards to usury deregulation. In 1996, the OCC pointed to *Marquette* to preempt strict state laws about the fees a bank could charge on a loan. Though these fees were not technically interest, they still amounted to an additional cost of borrowing loans. Thus, many states had laws that restricted banks from charging excessive fees on loans. Through its ruling, the OCC overruled states that limited these fees. The OCC wrote that, "This interpretation is consistent with OCC precedent and regulations governing the definition of 'interest' for purposes of Section 85 as upheld by the Supreme Court."[73] The OCC included a footnote at the end of this section specifying that it was referring to *Marquette.* Thus, the OCC used the tool of preemption to further deregulate the ability of states to protect their consumers from excessive borrowing costs from national banks. In 2001, the OCC again used federal preemption that was derived from *Marquette* to preempt states that were restricting national banks from lending for auto-loans.[74] A year later, in 2002, the OCC used preemption to allow national banks to circumvent state restrictions on costs associated with conducting

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[71] United States. Cong. House. Committee on Banking, Finance and Urban Affairs. *Hearing on H.R.2515,* April 3 and 5, 1979. 96th Congress. First Session. Washington (Statement by John Heimann, Comptroller of the Currency).
[72] See "Congressional Deregulation"
[73] Williams, Julie L. "Interpretive Letter 744." Department of Treasury, The Office of the Comptroller of the Currency,, 21 Aug. 1996, www.occ.treas.gov/topics/licensing/interpretations-and-actions/1996/int744.pdf
[74] Preemption Determination, 66 FR 100 (May 23, 2001)

"business using electronic technologies."[75] Thus, in the 1990s and early 2000s, the OCC used preemption, a tool given to it by the Burger Court, to get around state laws that roadblock them from achieving their goal of increasing bank profitability.

II. Federal Home Loan Bank Board (FHLBB)

The FHLBB made even quicker use of its federal preemption ability after *Marquette.* In 1980, the FHLBB issued an interpretation that preempted state interest rate maximums on loans that had been given to one borrower and then assumed by another borrower. Thus, a bank could allow a new borrower to assume another borrower's old loan at an interest rate that was higher than what was allowable by state laws.[76] Less than ten days later, the FHLBB issued another interpretation that preempted state laws that prohibited lenders from charging "points" on loans. The interpretation described a point as a "fee, premium bonus loan origination fee, service charge, or any other charge equal to 1% of the principal of a loan."[77] In both of these two interpretations, the FHLBB cited *Marquette* in deriving its authority to preempt state laws.

Lastly, two months after these interpretations, the FHLBB put out a final rule stating that preemption of state usury laws in housing loans can be applied to all loans made by federally chartered banks, credit unions, thrifts, state chartered banks insured federally, members of the Federal Reserve or FHLB, and all loans that are insured or invested in by HUD, FNMA, FHLMC, or GNMA.[78] Through these three interpretations, the FHLBB took the preemption tool bestowed onto it by the Supreme Court and used it to deregulate interest rate controls on the mortgage market.

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[75] Electric Activities, 69 Fed Reg 96 (May 17 2002)
[76] Notice of Agency Interpretation, 45 FR 18 (January 25, 1980)
[77] Notice of Agency Interpretation, 45 FR 26 (February 6, 1980)
[78] Regulations for Federally Related Mortgage Loans; Preemption of State Usury Laws, 45 FR 70 (April 9, 1980)

III. State Deregulation

Unlike federal regulatory agencies, preemption served as a regulatory roadblock for state regulators. Allowing preemption of state interest rate limits impeded the ability of a state agency or legislature to regulate the interest rates charged to borrowers in their state.[79] Further, because banks in states with low interest rate maximums were becoming less profitable, states feared that banks would seek to re-charter in other states to reap the benefits of higher interest rates. In order to prevent this from happening, states that had traditionally strict interest maximums loosened their rules to permit the charging of higher interest rates. In 1979, one year after *Marquette*, many states increased their interest rate limits. Illinois, Missouri, New Jersey, New York, Tennessee, and Texas all eased their interest rate maximums, and in subsequent years many states continued to follow their direction.[80] By allowing federal preemption of usury laws, the Court set off a "race towards the bottom" as states sought to deregulate their interest rate maximums in order to attract national banks to their state, or at the very least, keep national banks from leaving their states.[81] This race to the bottom even furthered the deregulation of interest rate caps.

IV. Congressional Deregulation

Though not an agency, Congress can enact statutes that govern the conduct of banks, and therefore can also act as a banking regulator. Because Congress also acts as a federal regulator over banks, it was also given the tool of preemption by *Marquette.* Congress was quick to draft bills and enact laws that used this newfound regulatory tool. In 1979, Congress set a temporary

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[79] *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299, Writ of Certiorari from Minnesota (1978)).
[80] *Current Economic Comment by District, Feb. 1979 – Jan. 1979*
[81] Lewis, Adam J. "Hydraulic Regulation: Regulating Credit Markets Upstream." *Yale Journal on Regulation*, vol. 26, no. 123, 2009, p. 157. *LexisNexisAcademic*

national interest rate limit on all business and agricultural loans of $25,000 or more, and preempted all state limits that considered the new national rate usurious.[82] The act also asserted that no member bank of the Federal Reserve, FHLB, or federally insured bank was subject to state interest rate laws if a state had a cap at less than 10%. Shortly after this act, Congress passed *Automatic Transfer Accounts at Commercial Banks Authorization.*[83] This act temporarily preempted all state laws explicitly limiting the rate or other fees that a bank may charge on future loans or mortgages that were secured by a first lien on the property. Congress relied on its preemptive authority to pass this law, specifically using the word preempt 14 times in the relatively short legislation. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) then made these temporary preemptions permanent.[84] Through these bills, Congress took a regulatory tool that it was given by the Supreme Court, preemption, and turned it into statutory deregulation of interest rate caps. After *Marquette,* Congress had a clear and legitimate legal basis to preempt state laws. In this way, *Marquette* had a significant impact on statutory interest rate deregulation.

C. Interest Rate Caps on Bank and Thrift Loans Conclusion

The *Marquette* decision brought on a wave of deregulation in the banking system. The decision provided regulators with goals to ease interest rate restrictions a tool – preemption – they could use to do so. The OCC and the FHLBB, who were motivated to help their regulatory

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[82] An Act to authorize on a Temporary Basis Certain Business and Agricultural Loans, Notwithstanding Interest Limitations in State Constitutions or States, and for Other Purposes. Pub. L. 96-104. 93 Stat. 789. 5 Nov 1979. *Congress.gov*

[83] An act to authorize automatic transfer accounts at commercial banks, remote service units at Federal savings and loan associations, and share draft accounts at Federal credit unions during that period beginning on December 31, 1979, and ending on April 1, 1980. Pub. L. 96-161. 93 Stat. 1233. 28 Dec 1979. *Congress.gov*

[84] Depository Institutions Deregulation and Monetary Control Act of 1980. Pub. L. 96-221. 94 Stat. 132. 28 Dec 1979. *Congress.gov*

clients remain profitable, used preemption to expand the array of state interest rate laws that national banks were able to circumvent. Congress, whose main motivation was reelection, were heavily influenced by industry lobbyists and campaign contributions to deregulate interest rate caps.[85] At the same time that the FHLBB, OCC, and Congress were pushing towards their goal of interest rate cap deregulation, state regulators with goals to protect their citizens from usury were roadblocked by preemption from doing so. States with strict usury laws saw banking activity migrate away. These states were ultimately forced to make a decision to conform to the trend of deregulation in usury or decimate their state's banking system. In this manner, the Supreme Court helped decide that the deregulatory goals of removing restrictions on interest rates would be achieved at the expense of the pro-regulatory goals of maintaining restrictions on bank loans. Over time, this allowed the Supreme Court to significantly impact the deregulation of interest rate maximums on bank loans.

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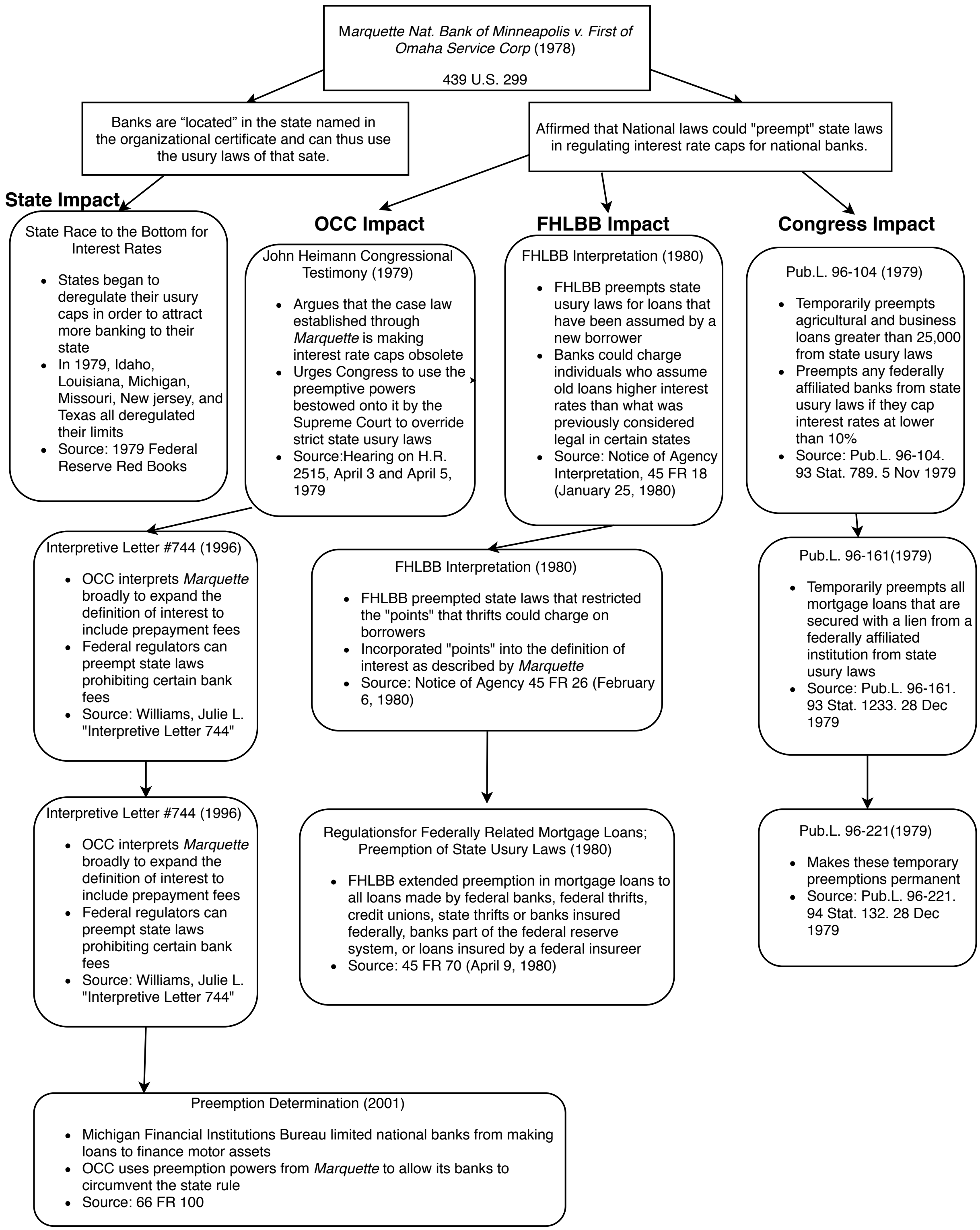
[85] Pizzo, Stephen, et al. *Inside Job: the Looting of Americas Savings and Loans.* HarperPerennial, 1991. Pg. 2

Figure 5: ***Regulatory Impact of Marquette***



Part 4: Case Study 2 – Geographic Expansion of Banking

Bank expansion has been a contentious topic in the United States since the country's inception. In a typical economic model, resources flow from an area of richness to an area of scarcity. In banking, this usually means that savings flow from agricultural areas to industrial areas. This is because agricultural areas tend to have rich savings after their harvests, and industrial area tends to need savings to invest in capital. However, in early United States, this savings flow did not occur. This is because the policy makers in agricultural areas of the United States, predominately the south, tended to be of the planter class.[86] Members of the planter class did not want to entangle planter savings with industrial interests. Planter opposition to integrating agrarian and industrial banks helped lead to the demise of the Second National Bank.[87] It was not until non-planter society in the South could gain control of the banking sector that capital could flow from agrarian South to develop the industrial southern cities such as Charlotte and Atlanta.[88] However, policies in many states continued to prohibit banks from expanding past the limits of their towns, and in many cases, from expanding past the walls of their own buildings.

During the Civil War, the National Banking Act established the OCC, which officially chartered national banks. However, the McFadden Act of 1927 forced chartered banks to obey state branching laws. This gave state bank regulators the ultimate control of bank expansion. National banks in many states, especially agriculture-dominated states in the South and Midwest, were prevented to expand by strict state branching laws. Figure 6 demonstrates the extent that state branching laws limited the ability of banks to geographically expand. In states such as

[86] Hills, Thomas D., "The Recent Rise of Southern Banking." Thesis, Georgia State University, 2006. p. 20. http://scholarworks.gsu.edu/history_theses/9
[87] ibid, 15-16
[88] ibid, 21

Kansas, Nebraska, and Missouri, national banks were prohibited from expanding past the limits of their own building as recently as 1979.[89]

In many ways, this geographic restriction on banks was harmful. Banks who were confined to small areas had bank portfolios that were completely tied to the economic condition of that area. If a bank was restricted to only make loans in a rural town in Missouri, and that town was struck by a major tornado, that bank could easily fail. If a tornado hits, depositors would take money out of the bank to pay for their property damages, and at the same time, borrowers would have to forgo paying their loan payments to pay for the tornado damage. Banks have always sought to get around tight geographic restrictions to prevent issues like this from being a problem. One way banks tried doing so was through bank holding companies. Bank holding companies were companies who owned banks. These holding companies would purchase banks in different areas to get around strict branching laws and diversify their loan portfolio. However, because these companies circumvented the intent of strict branching laws, regulators sought to restrict their growth ability. The Bank Holding Company Act of 1956 made it so all bank holding companies had to register with the Federal Reserve and meet the Fed's regulatory requirements. The Federal Reserve had to approve any bank holding company expansions, and Bank Holding Companies were restricted from buying banks in different states.

In this section, I review the Court's impact on three separate methods of bank expansion used by banks and bank holding companies during the era of the Burger Court.

A. Geographic Expansion Method 1: Branching

The most basic method of bank expansion is bank branching. Branching is when one bank opens up new facilities. In order for a bank to branch, a state bank must get approval from

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[89] Mengle, David L. 1990. "The Case for Interstate Branch Banking." Federal Reserve Bank of Richmond Economic Review 76 (November/December): 3–17.

its state regulator and national banks must get approval from the Office of the Comptroller of the Currency (OCC). Further, a member of the Office of the Comptroller of Currency is restricted by the McFadden Act to only approve of branching activity that would be allowable under the law of the state where the national bank is located. State regulators can intervene when the OCC approves a national bank to branch if that state regulator believes the branch is against state laws. This leads to a potential conflict when state and national regulators differ in their approval of a proposed branch of a national bank. In 1969, the Supreme Court heard a case that revolved around this conflict.

I. *First National Bank in Plant City v. Dickinson (*1969)

In the 1960s, Florida had a policy of unit branching. This means that a bank was not allowed to branch outside of the walls of its own building.[90] One bank, First National Bank in Plant City, had plans to begin using an armored car to pick up deposits for its commercial clients. At the same time, the bank also opened a receptacle where its retail clients could drop off their deposits. The armored car could thus come and pick up these deposits and bring them to the bank. The OCC approved these new services so long as the customers signed a contract saying that the armored car was the agent of the customer and not the agent of the bank. Before the armored car service began, the Florida Comptroller of the Currency, Fred Dickinson, sent a cease and desist letter to the national bank. The letter said that the armored car and receptacle services constituted branching under Florida Law and was, therefore, illegal.[91] This seemed valid to the Florida Comptroller of Currency because federal law dictated that, if state banks were unable to

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[90] Florida Stat. § 659.06(1)(a)(1965)

[91] *First National Bank In Plant City v. Dickinson,* Complaint Filed in District Court, 396 U.S. 122, 15-24 (1966)

Figure 6: State Branching Laws, Selected Years

	1910	29	39	61	79	90
Alabama		•	♦	♦	♦	♦
Alaska	–	–	–	■	■	■
Arizona	–	■	■	■	■	■
Arkansas		•	•	•	♦	♦
California	■	■	■	■	■	■
Colorado	•	•	•	•	•	•
Connecticut	•	•	■	■	■	■
Delaware	■	■	■	■	■	■
Florida	■	•	•	•	♦	■
Georgia	■	♦	♦	♦	♦	♦
Hawaii	–	–	–	■	■	■
Idaho		•	■	■	■	■
Illinois		•	•	•	•	♦
Indiana		•	♦	♦	♦	♦
Iowa		•	•	•	♦	♦
Kansas		•	•	•	•	■
Kentucky				♦	♦	♦
Louisiana	♦	♦	♦	♦	♦	■
Maine	♦	♦	■	■	■	■
Maryland		■	■	■	■	■
Massachusetts	•	♦	♦	♦	♦	■
Michigan			■	♦	♦	■
Minnesota		•	•	•	•	♦
Mississippi	•	♦	♦	♦	♦	■
Missouri	•	•	•	•	•	•
Montana		•	♦	♦	•	♦
Nebraska		•	•	•	•	♦
Nevada	•	•	■	■	■	■
New Hampshire					♦	■
New Jersey		♦	♦	♦	■	■
New Mexico	–	•	•	♦	♦	♦
New York	♦	♦	♦	♦	■	■
North Carolina		■	■	■	■	■
North Dakota			•	•	•	■
Ohio		♦	♦	♦	♦	■
Oklahoma				•	•	■
Oregon	■	•	■	■	■	■
Pennsylvania	•	♦	♦	♦	♦	■
Rhode Island	■	■	■	■	■	■
South Carolina		■	■	■	■	■
South Dakota			■	■	■	■
Tennessee	■	♦	♦	♦	♦	■
Texas	•	•	•	•	•	■
Utah		•	■	■	■	■
Vermont		■	■	■	■	■
Virginia		■	■	♦	■	■
Washington	■	•	■	■	■	■
West Virginia		•	•	•	•	■
Wisconsin	•	•	•	•	♦	♦
Wyoming					•	■

KEY
- • Unit banking (branching prohibited)
- ♦ Branching limited geographically within state
- ■ Statewide branching
- No branching law
- – Not yet a state

Source: Mengle, David L. 1990. "The Case for Interstate Branch Banking." Federal Reserve Bank of Richmond Economic Review 76 (November/December): 3–17.

branch, national banks could not branch either.[92] State banks were prohibited from providing similar car and receptacle services because Florida regulators considered those activities branching. However, it was unclear whether the car and receptacle services constituted branching under federal law. First National challenged Dickinson's cease and desist order, arguing that the services were not branching activities under the federal law and thus, were not prohibited by Florida's laws banning branching.

There were two important legal questions involved in *Dickinson.* First, which definition of "branching" should be used in determining if a banking activity is considered branching: the state or federal definition. If the state definition should be used, then the armored car services were considered branching in Florida and should not be allowed. However, if the national definition of branching was the definition that should be used, then it begged a second question: do the armored car and receptacle services provided by Plant City constitute branching under the federal definition of branching. The Fifth Circuit Court of Appeals determined that the state definition preempted federal definition, and therefore, the OCC approved activities were not permitted in Florida.[93] The Supreme Court ultimately held that federal law preempted state law in determining the definition of branching. However, the Court held that even under the federal definition of branching, armored car and receptacle services were considered branching.[94] The majority opinion was written by Chief Justice Burger and was supported by Justices Black, Harlan, Brennan, Marshall and White. Justice Douglas wrote a dissenting opinion that was supported by Justice Stewart.

II. Regulatory Response

[92] 12 U.S.C. § 36(f)
[93] Dickinson v. First National Bank in Plant City, 400 F.2d 548 (5th Cir. 1968)
[94] *First National Bank In Plant City v. Dickinson,* 396 U.S. 122 (1969)

Though the Supreme Court ultimately did not allow First National to operate its new services, it did allow federal regulators to preempt state regulators in determining whether an activity was considered branching. This preemption provided a tool for federal regulators who sought to remove restrictions on national banks from expanding. At the same time, federal preemption provided a regulatory roadblock to state regulators who sought to restrict bank expansion.

a) State Response

Because the Fifth Circuit Court of Appeals decided that the state definition of branching should be considered over the federal definition of branching, it created a natural experiment for the three years before Supreme Court heard the case. Fort those three years, regulators acted upon the assumption that the state definition of branching overrode the federal definition.[95] It provides a glimpse at what would have happened if the Supreme Court had affirmed that states could preempt the national definition of branching.

After the Fifth Circuit decision, state regulators began to alter their definitions of branching in order to ban activities that would not be considered branching under federal law. In Illinois, where there was a unit branching policy, the banking commission and state Attorney General deemed all off premise banking activity branching. This included the newly popular "Lectro Tellers," which served as predecessors to the modern day ATM.[96] In Georgia, state courts used *Dickinson* (5th Cir. 1968) to strengthen their branching laws restrictions. In one case, the Court said that, because of *Dickinson* (5th Cir. 1968), calling potential customers off premises or closing deals off premises would be considered branching. Thus, simply making a phone call

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[95] *First National Bank In Plant City v. Dickinson,* Motion for Leave to File Brief for the First National Bank of Corneilia, Georgia, Georgia et. al. Amicus Brief in Support of Petitions for Writs of Certiorari, 396 U.S. 122, 1-22 (1968)
[96] ibid

to a customer outside of the bank building was banned in Georgia.[97] Lastly, the Attorney General in North Carolina, citing Dickinson (5th Cir. 1968), ruled that all loan production offices outside of a bank constitute a branch. This was important because many banks had arrangements with car dealerships where the dealership would help their clients fill out loan applications for automobile financing loans. Through the North Carolina Attorney General's ruling, this practice was considered branching and was therefore prohibited.[98]

The lower court ruling provided state authorities with goals to restrict bank expansion a regulatory tool, state preemption, to achieve their goal. Through the examples provided above, it is clear that states used this tool to restrict bank expansion. After the Supreme Court gave the power to define branching back to federal authorities, it restricted state authorities from expanding their definitions of branching to include any activity the state regulator wanted to prohibit. This provided state regulators with a regulatory roadblock, federal preemption, which impeded states with goals of restricting bank expansion.

b) Office of the Comptroller of the Currency (OCC)

For the OCC, the ruling provided them with a new tool to foster bank expansion. The OCC, always looking for ways to promote the interests of their regulatory clients, sought to increase national bank expansion. Giving national banks a greater ability to expand than state banks, which were still bound to the state definition of branching, would allow the OCC to attract state banks to re-charter as national banks. Thus, the OCC used *Dickinson* to limit the federal definition of branching in a way that removed many restrictions on national bank expansions. As one example, in 1974, the OCC ruled that the use of Customer-Bank

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[97] Jackson vs. First National Bank of Corneilia, Georgia ;N.D. G.A. Cir 1191 (10121, 68)]
[98] *First National Bank In Plant City v. Dickinson,* Motion for Leave to File Brief for the First National Bank of Corneilia, Georgia, Georgia et. al. Amicus Brief in Support of Petitions for Writs of Certiorari , 396 U.S. 122, 1-22 (1968)

Communication Terminals (CBCT) was not considered branching. These terminals, which were generally located in convenience stores, allowed bank customers to initiate bank transactions and withdrawal off premise. The ruling allowed national banks in states with strict branching laws to make use of these terminals and expand their banks' clientele. In making this ruling, the OCC referenced *Dickinson* in asserting that it has the power over states to define branching. This preemptive tool allowed the OCC to override any state rules banning CBTCs as branching activities.

In 1985, the OCC again used *Dickinson* to strengthen the ability of national banks to branch. In Mississippi, state commercial banks were prohibited from branching outside of 100 miles of their principal location. However, at the same time, Mississippi thrifts were able to branch throughout the state. The OCC ruled that, because thrifts offered many traditional "banking" services, national banks should be able to expand as far as thrifts. Subsequently, the OCC permitted national banks to branch throughout the state. This was challenged in Court, but the Fifth Circuit ruled that, because *Dickinson* established that the definition of branching was subject to national law and not state law, the OCC's ruling was correct.[99] In this example, *Dickinson* again provided the OCC with a tool, federal preemption of the definition of branching, which allowed it to further deregulate bank branching regulations.

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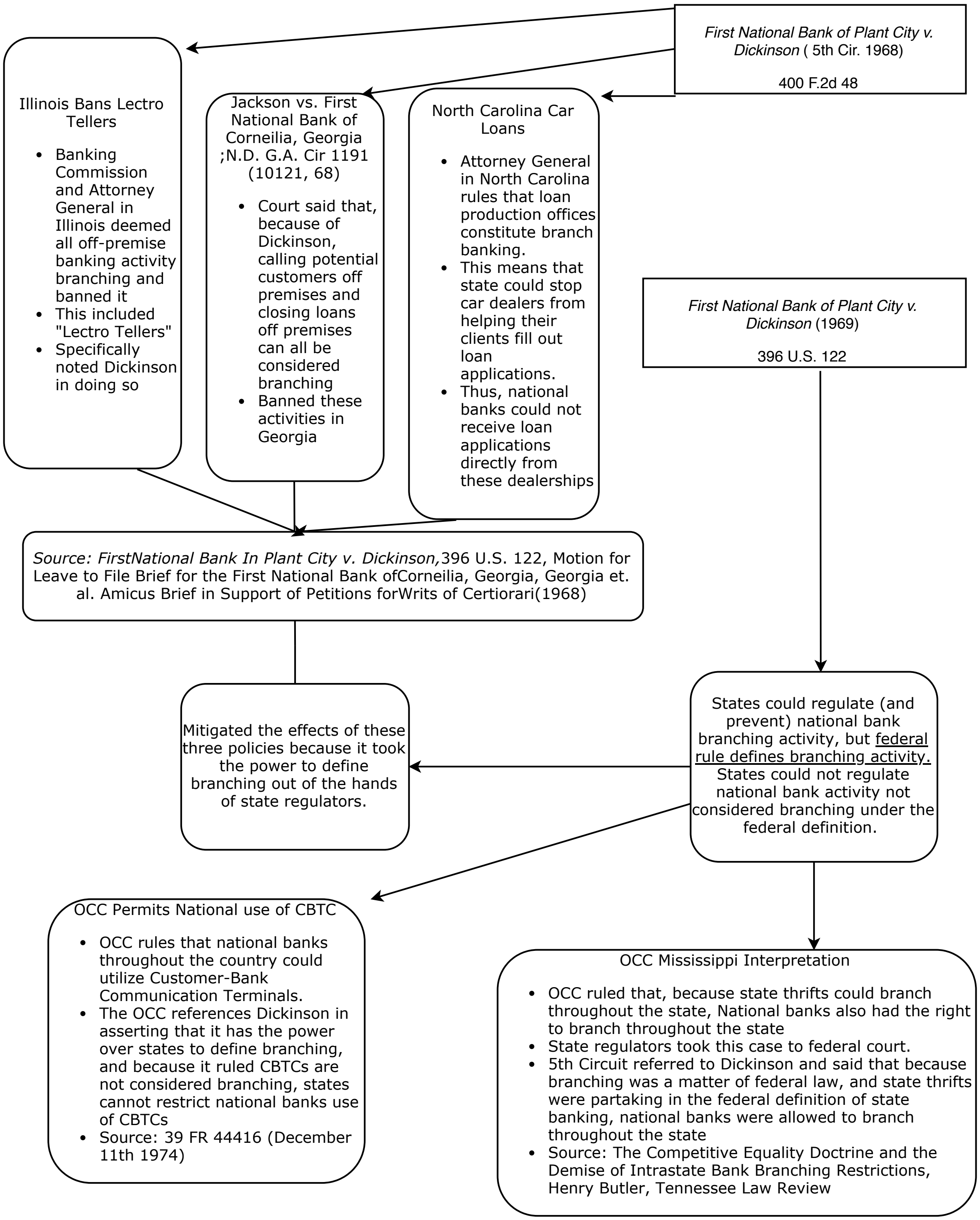
[99] Butler, Henry M. "The Competitive Equality Doctrine and the Demise of Intrastate Branching Restrictions." *Tennessee Law Review,* vol. 55, no. 703, 1988, pp. 703-732. *LexisNexis Academic;* Deposit Guaranty, 809 F.2d at 268

Figure 7: Branching Regulation Flow Chart



B. Geographic Expansion Method 2: Mergers and Acquisitions

In order to get around strict branching laws, many banks and bank holding companies attempted to merge or acquire other banks in new districts. By doing this, banks and bank holding companies gained two benefits. First, they could expand in a manner that allowed them to gain a more diversified portfolio of depositors and loans. Second, they could lessen their competition by merging with or acquiring a direct competitor or a potential competitor. Because of these benefits, the Office of the Comptroller of the Currency and the Federal Reserve were generally willing to approve reasonable merger and acquisition requests of national banks or bank holding companies. However, because mergers and acquisitions can have anticompetitive effects, antitrust regulators such as the Antitrust Division of the Department of Justice (DOJ) and the Federal Trade Commission began to challenge bank mergers and acquisitions. In 1974, this culminated in a multi-case Supreme Court battle between two government agencies of the same administration: the OCC and the DOJ.

I. *United States v. Marine Bancorporation* (1974) and *United States v. Connecticut National Bank* (1974)

*United States v. Connecticut National Bank (*1974) and *United States v. Marine Bancorporation* (1974) were both legal battles between the DOJ and the OCC. These two cases were decided on the same day and had nearly identical ideologically divided votes. At the heart of this debate was the scope of the DOJ's ability to block bank mergers using Section 7 of the Clayton Act. Section 7 allowed the government to block mergers or acquisitions that could produce substantial anti-competitive effects.[100] The Supreme Court had already determined that

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[100] 15 U.S.C. 18

the government could use this provision to block mergers in the banking industry.[101] However, Congress clarified in the Bank Merger Act of 1966 that banks were allowed to merge if the anti-competitive effects of the merger were outweighed by the benefits to the community affected by the merger.[102]

In these two cases, the Supreme Court decided two major issues. First, the court had to decide whether the potential competition doctrine could be used to block a merger under Section 7. In *Marine Bancorporation,* the DOJ tried to stop an OCC approved acquisition under Section 7 because, it argued, the merger would diminish competition.[103] Though the two merging banks did not directly compete with each other at the time of the acquisition, the DOJ argued that there was a possibility that they would one day be competitive. The DOJ derived this from an antitrust doctrine called the potential competition theory. This doctrine argues that if "Company A" in "Market A" raises its price, other similar companies would want to enter "Market A" to reap the benefits of a higher price. Because of this potential for competition, "Company A" will keep its prices low to stave off potential competition.[104] Using this doctrine, the DOJ argued that the proposed merger would eliminate the potential competition that the two banks presented each other, and thus, eliminate the downward pressure that was keeping interest rates down for bank consumer. Ultimately, the DOJ's challenge of the acquisition made its way to the Supreme Court, and the OCC joined the case on behalf of the acquiring bank, Marine Bancorporation.

The OCC and Marine Bancorporation argued that there was no violation of Section 7 of the Clayton Antitrust Act because there was no real potential competition. According to the OCC and Marine Bancorporation, the strict state branching laws limiting the ability of the two banks

[101] *United States v. Philadelphia National Bank,* 374 U.S. 321 (1963)
[102] 12 U.S.C. 1828
[103] United States v. *Marine Bancorporation,* Jurisdictional Statement, 418 U.S. 602, 3 (1974)
[104] ibid

to enter each other's markets made it so the two banks did not consider each other potentially competitive.[105] In a decision that was split along ideological lines, the Supreme Court agreed with the OCC and Marine Bancorporation's argument. In an opinion written by Justice Powell and supported by Justices Burger, Stewart, Blackmun, and Rehnquist, Powell argued that the potential competition doctrine must take into account federal and state regulations that make it difficult for firms to enter markets.[106] When it is unlikely that Bank A in Market A can expand into Market B because of strict branching laws, Bank A and a bank in Market B are not potential competitors. This was important because it limited the ability of the DOJ to block bank mergers and acquisitions using the potential competition doctrine in states with strict branching laws.

In addition to potential competition, the second important issue the Court decided in *Marine Bancorporation* and *Connecticut* was regarding the DOJ's "relevant market." When the DOJ argues that a merger will create anticompetitive effects under Section 7, it must establish a relevant market that would lose market competition if the merger were to go through. In *Marine Bancorporation* and *Connecticut,* the merging banks and the OCC challenged the relevant market that was established by the DOJ. In *Connecticut,* the DOJ wanted the "standard metropolitan statistical area" (SMSA) to be the relevant market in determining whether a merger between Connecticut National Bank (CNB) and First New Haven Bank (FNH) would have anticompetitive effects. An SMSA was a measure of a geographical area related to a single metropolitan area that was used by the census bureau for statistical purpose. The DOJ could easily show that the proposed merger would greatly increase the percentage of deposits owned

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[105] United States v. *Connecticut National Bank,* Brief for the Comptroller of the Currency 418 U.S. 656, 62 (1974)
[106] United States v. *Marine Bancorporation,* 418 U.S. 602 (1974)

by one bank in the bank's SMSA.[107] The banks and the OCC argued that the SMSA was not a relevant market to commercial banking, and therefor, the percentage of deposits owned in the SMSA was not relevant to Section 7.[108]

The Supreme Court agreed that the DOJ had the burden to produce sufficient evidence that its proposed "relevant market" was actually the local market that was relevant to the industry. In an opinion written by Powell and supported by Burger, Stewart, Blackmun, and Rehnquist, the Court affirmed that the SMSA was not a relevant market.[109] By placing the burden of proving that their its market was the true relevant market, the Supreme Court handicapped the ability of the DOJ to prosecute mergers with anticompetitive effects.

a) Regulatory Impact on the Potential Competition Doctrine

i. Department of Justice (DOJ)

In both *Connecticut* and *Marine Bancorportion,* the Supreme Court made it more difficult for the DOJ to use the potential competition doctrine to block a merger. According to Justice White's dissenting opinion in *Marine Bancorporation*, the case "erects formidable barriers to the application of the potential competition doctrine."[110] The potential competition doctrine was a tool that the DOJ had at its disposal to try to accomplish its goal of protecting market competition. However, by restricting the ability of the DOJ to use the potential competition doctrine, the Supreme Court restricted the DOJ from being able to achieve its goal. In this way, restricting the DOJ from applying potential competition doctrine served as a

[107] United States v. *Connecticut,* Brief for the United States, 418 U.S. 656, 34 (1974)
[108] United States v. *Connecticut,* Brief for the Office of the Comptroller of the Currency 33-39, 418 U.S. 656 (1974)
[109] United States v. *Connecticut,* 418 U.S. 656 (1974)
[110] United States v. *Marine Bancorporation,* 418 U.S. 602, 654 (1974)

regulatory roadblock for the DOJ. To this day, the DOJ has not successfully challenged any bank merger in court using the potential competition doctrine.[111]

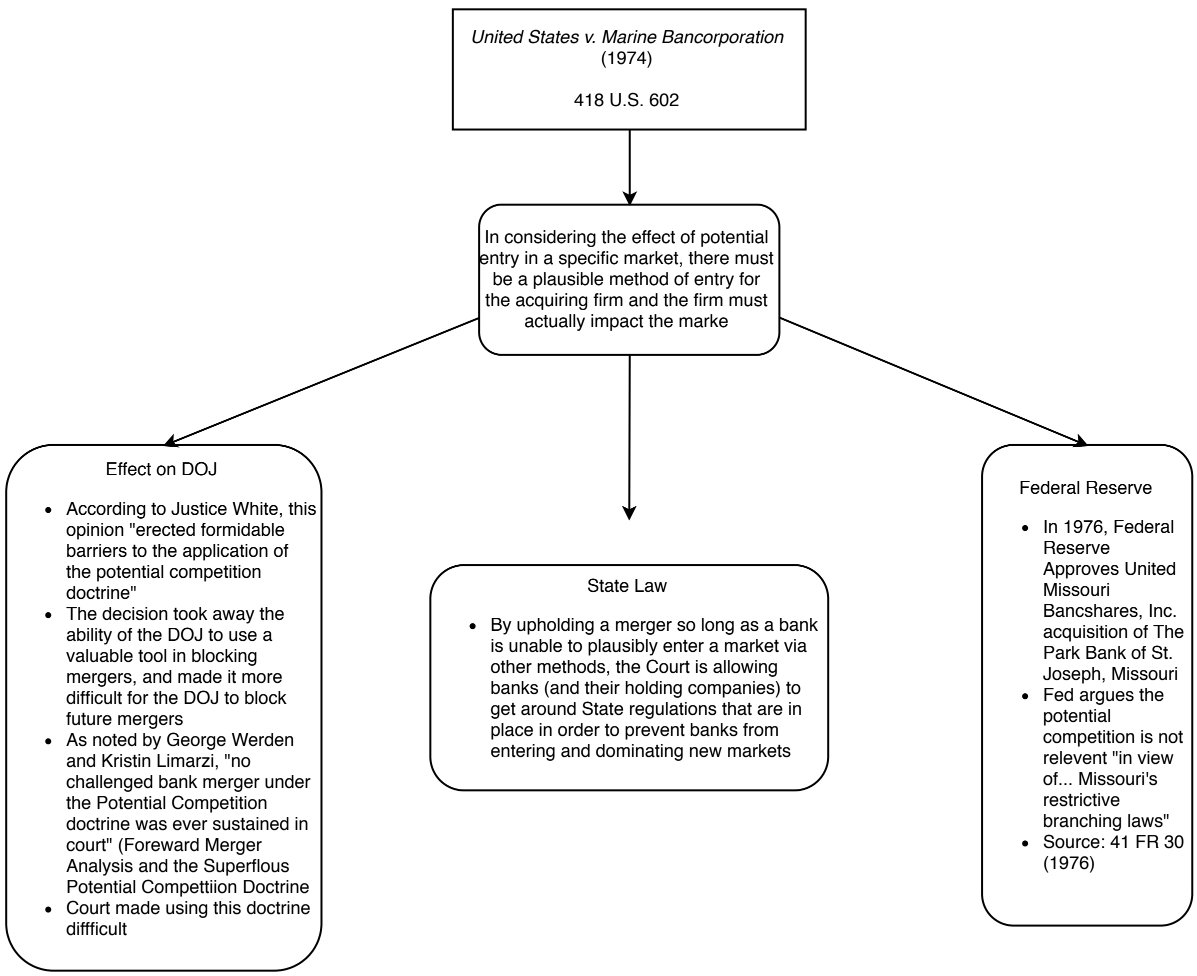
ii. The Federal Reserve

The Federal Reserve, which is the regulator who approves bank holding company acquisitions, used the Supreme Court decisions to approve new bank acquisitions by bank holding companies. In 1976, the Fed approved United Missouri Bancshares, Inc's acquisition of Park Bank of St. Joseph in Missouri. The Fed cited Missouri's' restrictive branching laws as the reason why the potential competition doctrine was not relevant to the case.[112] Through this approval, and others like it, the Federal Reserve fostered bank expansions that the state had sought to prevent through its strict branching laws. The Supreme Court, by withering away the potential competition doctrine, gave regulators who sought to foster bank expansion an easier path to do so. This is because regulators like the Federal Reserve could approve mergers and acquisitions without having to worry about costly potential competition challenges from other banking regulators.

[111] Walden, Gregory J, and Kristen C Limarzi. "Forward-Looking Merger Analysis and the Superfluous Potential Competition Doctrine" *Antitrust Law Journal,* vol 77, no. 109. *LexisNexis Academic*

[112] 41 FR 30 (Nov. 30, 1976).

Figure 8: Potential Competition Flow Chart



b) Supreme Court Regulatory Impact on Defining Relevant Markets

i. Department of Justice (DOJ)

Before *Connecticut* and *Marine Bancorportion,* the DOJ did not have to put significant resources to defining a relevant market as a part of their antitrust work. The Supreme Court decided in *The United States v. Pabst Brewing Company* (1966) that the failure to prove a relevant market was "not an adequate ground for dismissal" of a Section 7 case to block a merger.[113] In other words, the DOJ did not need to provide an adequate relevant market in order to block a merger under Section 7. This allowed the DOJ to use any "sufficiently differentiated section" as a relevant market.[114] The DOJ could use its ability to easily define a market to challenge many mergers. This is because if the DOJ wanted to prove that a merger would create anti-competitive effects, it could simply adjust the "relevant market" size until the market share percentages support their argument. In this way, being able to easily define the "relevant market" was an important regulatory tool for the DOJ.

After *Marine Bancoropration* and *Connecticut,* the DOJ could no longer establish a relevant market with *Pabst* ease. Instead, these cases affirmed that the DOJ could only use a relevant market that was no larger than the area in which the acquired firm was actually competing. It placed the burden on the government to prove that their provided market did capture the true scope of the competition.[115] Thus, the DOJ had to spend much more of its resources on producing the economic evidence necessary to prove its relevant markets were actually relevant. Using Seinfeld's purposive process as described in Part 1, this increased cost of

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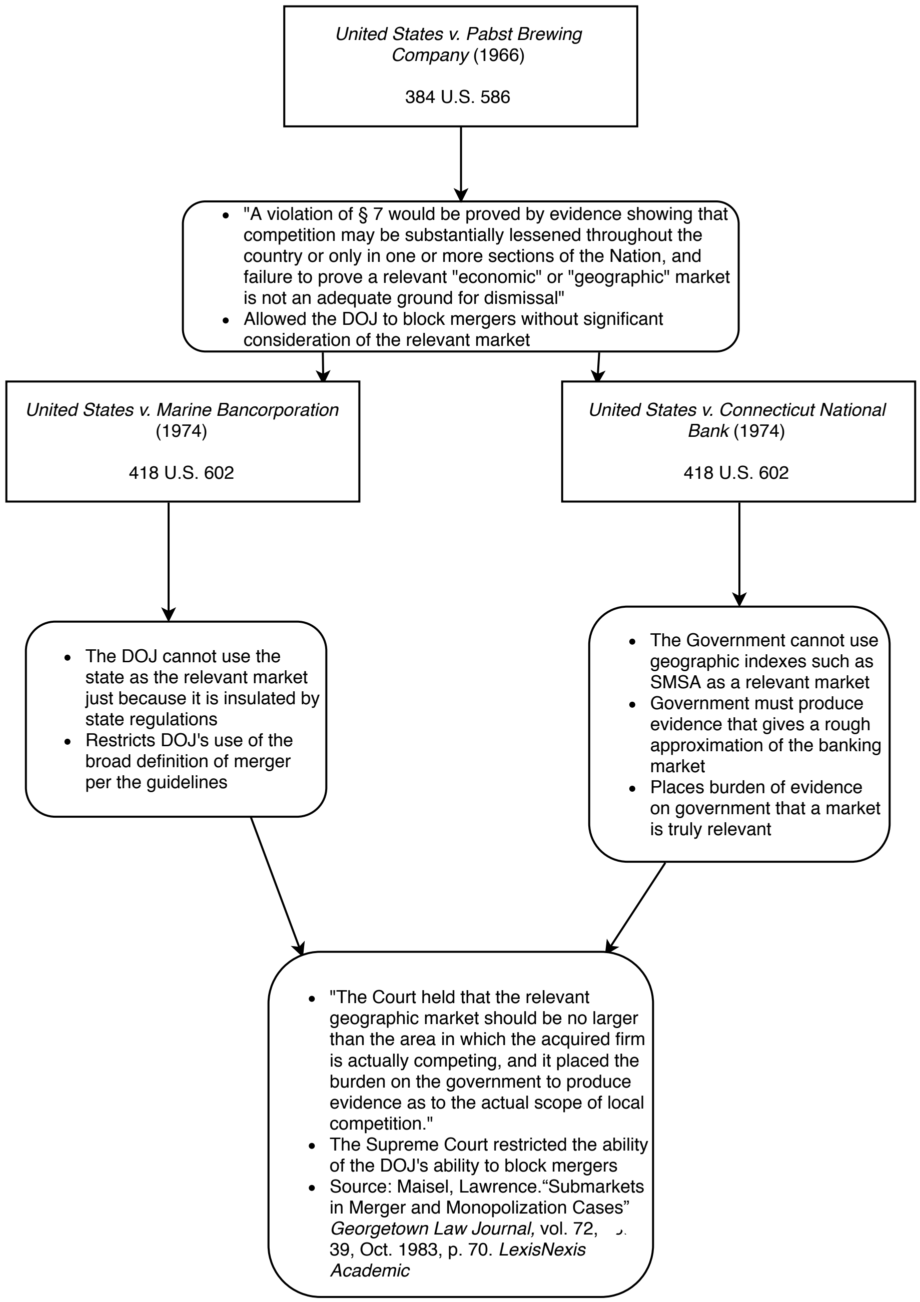
[113] *United States v. Pabst Brewing Company,* 384 U.S. 546, 549 (1966)
[114] Maisel, Lawrence C. "Submarkets in Merger and Monopolization Cases" *Georgetown Law Journal,* vol. 72, no. 39, Oct. 1983, p. 70. *LexisNexis Academic*.
[115] ibid

Figure 9: Defining Relevant Market Flow Chart



challenging mergers likely deterred the DOJ from pursuing as many antitrust cases as it previously had. By taking away the ability of the DOJ to easily establish a relative market, the Supreme Court provided the DOJ another regulatory roadblock in its effort to achieve its goal of protecting market shares.

C. Geographic Expansion Model 3: Special Arrangements

Because branching, merger, and acquisition policies were still too strict in some states for banks to expand, banks and bank holding companies began to use "special arrangements" for expansion. These arrangements typically involved multiple banks working with each other to act like one bank. This gave banks multiple benefits. First, banks could get around strict state and national regulations that restricted their ability to gain a diversified portfolio. Second, banks could use these special arrangements to eliminate competitors and to collectively set interest rates among banks in the arrangement. Because of this seemingly collusive behavior, the DOJ sought to regulate special arrangements to protect market shares and consumers. In 1975, the DOJ challenged one of these special arrangements, and the Supreme Court heard the case.

I. *United States v. Citizens & Southern National Bank* (1975)

Citizens & Southern National (C&S) was a banking organization located in Georgia that owned C&S Holding Company, a bank holding company. Before 1971, Georgia law prohibited branching throughout counties. This prohibited a bank based in the city of Atlanta from branching into Atlanta suburbs. Georgia law also prohibited bank holding companies from owning more than 5% of shares of two or more banks in one county. C&S Holding Company owned over 90% of two banks, one in Fulton County and the other in DeKalb County. These are the two counties that encompass much of Atlanta and its suburbs. However, responding to strict state laws, C&S Holding Company developed a special arrangement with many other Atlanta suburban banks. Throughout Fulton and DeKalb County, C&S would help organize a bank on paper and would then assist with the selling of that bank's stock. At the sale of the stock, C&S Holding Company would buy 5% of the bank's shares. I refer to these banks as 5% banks. Once these banks were operating, C&S Holding Company would afford them special privileges. This included use of the holding company's logarithm for setting interest rates, the use of bank strategy, and the use of bank's marketing and brand. These 5% banks would not compete with any other bank owned or partially owned by C&S Holding Company.[116]

This kind of special relationship is referred to as "De Facto Branching," because in effect, the 5% banks acted as branches for C&S Holding Company. After 1971, Georgia changed their laws to allow banks to legally branch throughout their counties. In response to the changes, the two national banks that C&S Holding Company owned more than 90% of (one in DeKalb County and one in Fulton County) tried to purchase all of the stock in each of the 5% banks in their respective counties. The FDIC approved these mergers. [117] The proposed organization structure of the C&S banking system can be seen in Figure 9. The DOJ initially challenged the mergers under Section 7 of the Clayton Act. As the case continued through the court system, the DOJ also challenged the de facto branching system that C&S had established.[118] The DOJ challenged that the C&S Holding through its special arrangements was illegally engaging in trust activity under Section 1 of the Sherman Act.[119]

The Supreme Court, in an ideologically driven vote, sided with C&S National over the DOJ. The Court ruled that the other de facto branches were immune to the Sherman Act because

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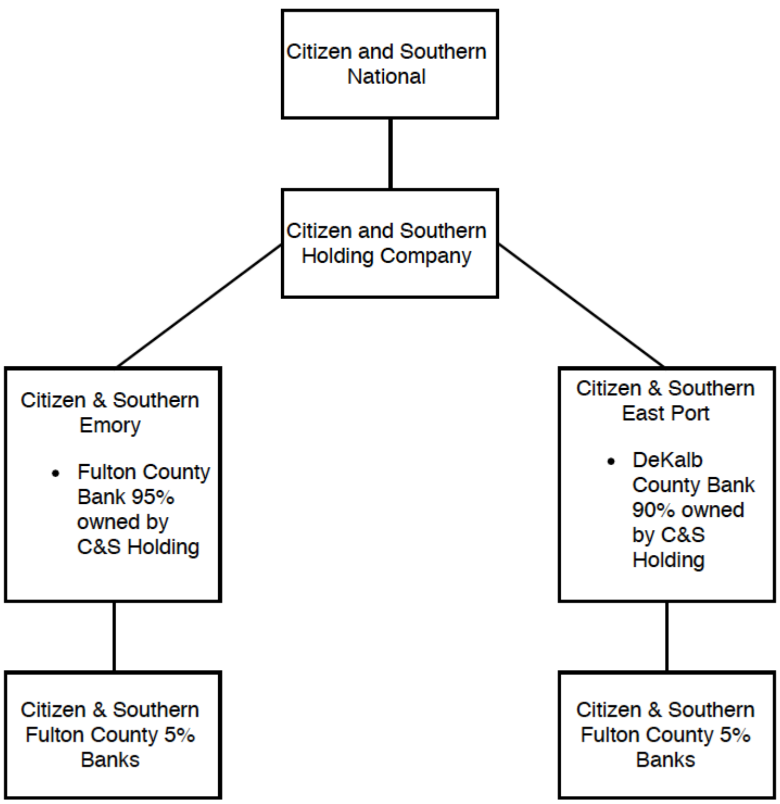
[116] *United States v. Citizens & Southern National Bank*, Complaint filed by the United States, 422 U.S. 86, 13-19 (1975).
[117] Ibid, 13-19; and *United States v. Citizens & Southern National Bank*, Brief of the United States, 422 U.S. 86 (1975).
[118] ibid, 19-21
[119] 15 U.S.C. §1

the lack of price competition between the de facto branches was the result of "sharing of expertise" and not "tacit agreements."[120] According to the Court, because Georgia branching and merging laws were so strict, these special arrangements were the only way banks could enter into new markets. The Court, finally, decided that the approved mergers did not violate Section 7 of the Clayton Act because the 5% banks would not extinguish present or potential competition because the banks had not previously been competing.[121]

Figure 10: C&S Propsed Organizational Structure after Acquisition of the 5% Banks



[120] *United States v. Citizens & Southern National Bank* 422 U.S. 86, 114 (1975)
[121] ibid, at 114

a) Supreme Court Regulatory Impact on Special Arrangements

By establishing that de facto branches do not result in a violation of the Sherman Anti Trust Act, bank holding companies were given a new tool to get around strict state and national geographic expansion laws. It also allowed the Federal Reserve to approve de facto branch acquisitions by bank holding companies. Lastly, it allowed the Federal Deposit Insurance Corporation (FDIC) and the OCC to approve acquisitions of de facto branches by the national banks. This gave these national regulators a regulatory tool that they could use to achieve their goal of fostering bank expansion.

i. Department of Justice (DOJ)

While *Citizens* & Southern gave regulators with goals to deregulate bank expansion an easier path to do so, it roadblocked antitrust regulators from achieving their goals. By permitting de facto branching, the Court made it more difficult for the DOJ to use Section 7 of the Clayton Act and Section 1 of the Sherman Act to achieve their goal of curtailing market concentration and protecting consumers. This proved to be a robust regulatory roadblock for the DOJ. At the same time as *Citizens & Southern,* the DOJ was challenging another special arrangement in Michigan established by Michigan National Corporation.[122] Shortly after the Supreme Court decisions, the DOJ put out a public notice that it settled with Michigan National. Michigan National agreed to divest its interest in one of their acquired de facto branches – one where it was abundantly clear there would be anti-competitive effects – in exchange that the DOJ drop their challenges of all other acquisitions by Michigan National. In its public notice about this

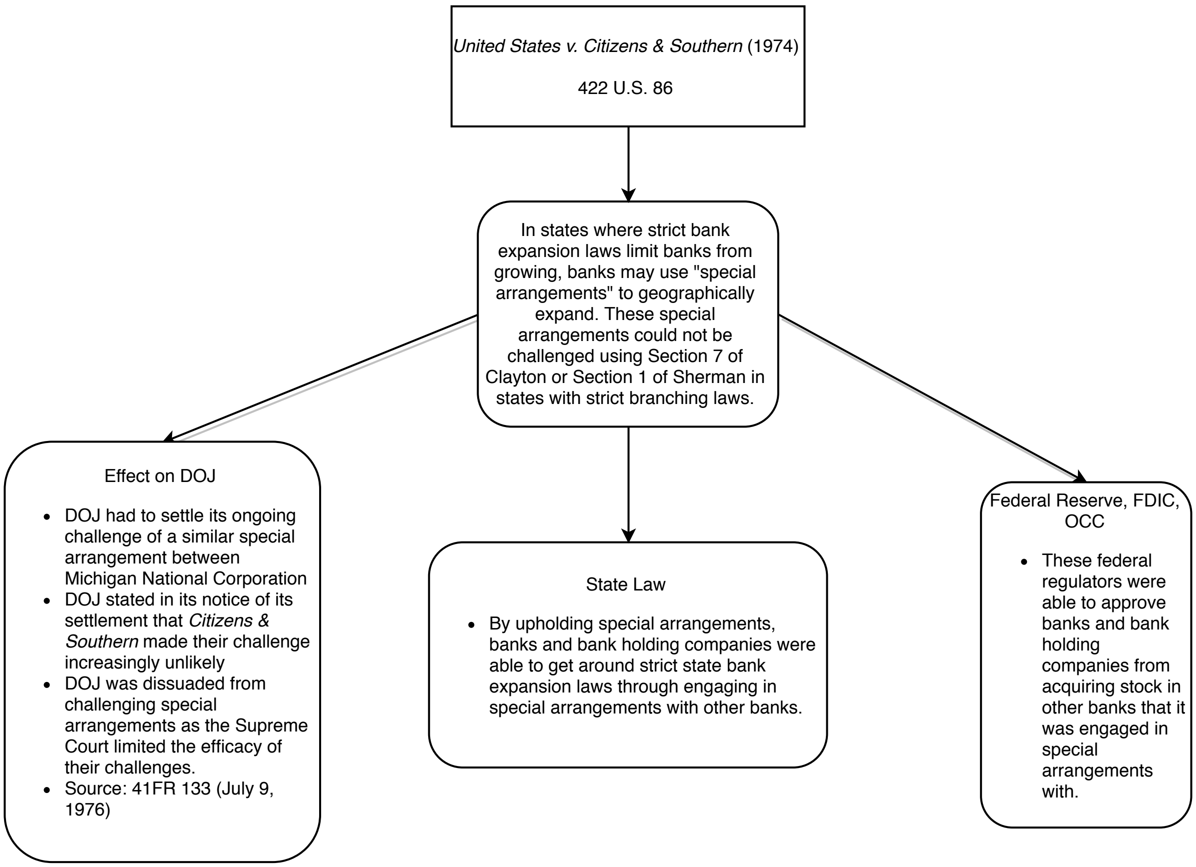
[122] 41 FR 133 (July 9, 1976)

settlement, the DOJ admitted that, after *Citizens Southern,* there was a "substantially reduced likelihood" of winning its challenge.[123]

The Michigan National Corporation settlement works to prove the regulatory roadblock aspect of my inter-branch theory. The DOJ had a goal to protect competition. It historically had used Section 7 of the Clayton Antitrust Act and Section 1 of the Sherman Act to block special arrangements between banks in order to block mergers that threatened competition. In *Citizen & Southern,* the Supreme Court inhibited the ability of the DOJ to use these antitrust statutes to block special arrangements that threatened competition. Because of this roadblock, the DOJ decided to drop its challenge and focus its resources on less roadblocked regulatory goals. Based on the DOJ's public notice for its Michigan settlement, it is likely that the DOJ declined to pursue subsequent special arrangement cases after *Citizens & Southern.*

[123] ibid

Figure 11: Special Arrangement Flow Chart



D. Geographic Expansion of Banking Conclusion

Throughout the cases presented in this section, the Supreme Court gave regulators with goals to foster geographic bank expansion the regulatory tools they needed to do so. By allowing federal regulators such as the OCC to preempt states in defining branching, the Supreme Court gave these regulators the ability to construe the definition of branching in a manner that permitted banks to expand in ways that had previously been deemed illegal in many states.[124] Similarly, by restricting the use of the potential competition doctrine for bank merger challenges, the Supreme Court gave federal regulators who wished to foster bank expansion the ability to approve bank mergers without fear of costly antitrust litigation.[125] Finally, by legitimizing the use of de facto branches in states with strict branching laws, the Supreme Court allowed regulators to approve special arrangements established by banks.[126]

While the Supreme Court was providing these tools to regulatory agencies with goals of deregulating geographic expansion of banking, they were creating regulatory roadblocks for agencies with pro-regulatory goals. By allowing federal regulators to preempt state definitions of branching, the Supreme Court restricted state regulators who wished to maintain tight restrictions on bank expansions.[127] Similarly, by allowing banks and bank holding companies to use mergers, acquisitions, and special arrangements to get around strict branching laws, the Court further restricted the ability of states to control bank expansion.[128] Lastly, in taking away the efficacy of antitrust doctrines like potential competition and statutes like the Sherman Act and the Clayton

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124 *First National Bank In Plant City v. Dickinson,* 396 U.S. 122 (1969)
125 United States v. *Marine Bancorporation,* 418 U.S. 602 (1974); United States v. *Connecticut,* 418 U.S. 656 (1974)
126 *United States v. Citizens & Southern National Bank* 422 U.S. 86 (1975)
127 *First National Bank In Plant City v. Dickinson,* 396 U.S. 122 (1969)
128 United States v. *Marine Bancorporation,* 418 U.S. 602 (1974); United States v. *Connecticut,* 418 U.S. 656 (1974); *United States v. Citizens & Southern National Bank* 422 U.S. 86 (1975)

Act, the Supreme Court roadblocked antitrust regulators from maintaining control of geographic bank expansion.

By continuously providing regulators with deregulatory goals with tools to accomplish their goals, the Supreme Court encouraged these regulators to continue to deregulate restrictions on bank expansion. At the same time, by continuously road blocking regulators with goals to maintain regulations on bank expansions, the Court encouraged these regulators to focus their limited resources on other goals. Over time, this helped lead to an overall trend of deregulation of bank expansion policies. Within 25 years of these Supreme Court cases, all national banks were allowed to expand throughout the country.[129]

Part 5: Case Study 3 – Repeal of Glass-Steagall

Glass-Steagall was legislation born in the midst of the Great Depression that banned commercial banks from engaging in most insurance or securities transactions.[130] Many policy makers during the Great Depression believed that commercial banks underwriting stocks and bonds contributed to over-speculation in the stock market and the resulting wave of bank failures.[131] Glass-Steagall separated commercial banks from financial institutions concentrating on securities transactions such as brokerage firms or investments banks. However, as discussed in Part 2, when commercial bank profits began to struggle due to the high inflation in the 1970s, commercial banks began to look for alternative sources of revenue.

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[129] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Pub. L. 103-328. 108 Stat. 2379. 20 Sep. 1994.

[130] Banking Act of 1933: Approved by President June 13 1933

[131] Brandl, Michael W. "Banking Regulation." *Money, Banking, Financial Markets & Institutions,* Cengage Learning, 2017, pp. 289-290

At the same time that commercial banking profits were reeling, financial innovations in the securities markets led to roaring profits for investment banks. The rise of money market funds (MMFs) led to a large supply of loanable funds that could be used in the short-term debt market.[132] This led to the growth of the commercial paper market. Commercial paper is a short-term unsecured promise to pay later that highly credible companies use to finance their short-term needs. Before commercial paper, these highly credible companies would use commercial banks to finance their short-term needs. However, because of Glass-Steagall provisions, commercial banks could not underwrite and sell commercial paper for companies. Therefore, large companies that used to borrow from commercial banks to finance their needs now turned to investment banks. Thus, as commercial banks lost profits with high inflation, a loss of depositors to mutual money funds, and a loss of borrowers to the commercial paper market, commercial banks began to see the value in having securities arms that could perform securities transactions such as underwriting and selling commercial paper.

A second securities market innovation that led to higher profits for securities dealers was the growth of private-label securitization. Private label securitization allowed securities dealers to pool bundles of loans and securities together and sell stock of these bundles to investors. Investors began to pour cash into various private-label securitization vehicles.[133] Seeing large profits in these securities activities, commercial banks were eager to profit off of private label securitization as well.[134] Throughout the 1970s and through the 1990s, banks and their federal regulators fought in many legal battles to allow banks to engage in securities transactions.

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[132] Wilmarth, Arthur E. "The Road to Repeal of the Glass Steagall Act." *Wake Forest Journal of Business and Intellectual Property Law.* 17: 446. *LexisNexis Academic.*
[133] Ibid, at 465
[134] Ibid, at 466

Though the Supreme Court did strike down some bank actions and bank policies[135], its decisions in the two cases presented in this section ultimately laid the groundwork for the official repeal of Glass-Steagall in 1999.[136]

A. *Board of Governors FRS v. Investment Co. Institute* (1981)

In 1972, the Federal Reserve issued a ruling amending Regulation Y – the rule stating what activities bank holding companies could engage in – allowing holding companies to establish investment advisory arms that could help establish and run closed-end investment-companies.[137] A closed-end investment company does not allow shareholders to redeem their shares for cash and cannot issue new shares at frequent intervals after the company is established. This is in contrast to an open-end investment company, such as an ETF or a mutual fund, which issues new shares quite often and allows shareholders to redeem their shares for cash. The closed-end "investment companies" that the Federal Reserve approved banks to advise were only companies on paper. The bank holding company advisory arm would establish a closed-end company without an office or employees. Then, the advisory arm would hand the company to an investment company to create and sell shares of the fund. Finally, once all of the shares were sold, the advisory arm would run the portfolio of the investment company as its "advisor."[138]

In its ruling, the Federal Reserve relied on Section 4(C)(8) of the Bank Holding Company Act (BHCA), which authorized the Board to allow bank holding companies to establish non-

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[135] *Securities Industry Association v. Board of Governors of the Fed. Reserve System,* 468 U.S. 137 (1984); *Investment Company Institute v. Camp,* 401 U.S. 617 (1971)
[136] Financial Services Modernization Act of 1999. Pub. L. 106-102. 133 Stat. 1338. 12 Nov 1999. *Congress.gov*
[137] 12 CFR 225.125
[138] *Board of Governors of the FRS v. Investment Company Institute,* 450 U.S. 46 Petition for a Writ of Certiorari, 6-8, (1981)

banking activity arms that were "so closely related to banking or managing or controlling banks as to be a proper incident thereto"[139] Many securities dealers, fearing that commercial banks would be added competition in their markets, fought back against the Federal Reserve ruling. These securities dealers feared that allowing commercial banks to engage in securities markets would add more competition to their markets. The Investment Company institute, a securities dealer lobbying organization, argued that the Federal Reserve overstepped its authority in their ruling. The Glass-Steagall Act restricted the participation of banks and their affiliates in specific securities industries. So the Investment Company Institute challenged the rule, and the challenge eventually made it to the Supreme Court.

The central question of the case was whether Section 4(C)(8) of the BHCA authorized Bank Holding Companies to establish investment advisory companies and manage these companies' portfolios. Investment Company Institute argued that the Fed's rulings violated Glass-Steagall because they engaged in securities activities by sponsoring the closed-end investment company. The Investment Company Institute continued that the BHCA does not permit a departure from pertinent Glass-Steagall prohibitions, even if an activity is close to banking.[140] The Federal Reserve argued that it were justified in their ruling because the organization and management of a closed-end investment fund was permissible activity under the Glass-Steagall Act. The Fed argued that they were not engaged principally in the issuance and marketing of the securities, and therefore were not in violation of Glass-Steagall

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[139] 12 U.S.C. §1843

[140] Oral Argument, *Board of Governors of the FRS v. Investment Company Institute,* 450 U.S. 46, (1981), cited on Oyez p. 10

prohibitions. The Fed also argued that its decision was entitled to judicial deference with regards to deciding what non-banking activities were allowed.[141]

Ultimately, the Supreme Court unanimously sided with the Fed. The Court said that its amendment to Regulation Y did not exceed the Board's statutory authority. In his opinion, Justice Stevens included many details that would later be used by banking regulators to justify further deregulation. Justice Stevens noted that bank affiliates might be authorized to engage in activities that banks themselves are prohibited from engaging in.[142] In particular, Stevens stressed this was true if the benefits the affiliates could be expected to produce in engaging in these activities outweighed possible adverse effects of their securities activities.[143] Further, Stevens affirmed that the Board should be granted "greatest deference" with regard to their decision-making on non-banking activities to be permitted.[144]

I. Regulatory Impact

The relevant regulatory agencies with goals to integrate securities activities and commercial banking were the agencies that were in charge of approving banks and bank holding companies to acquire new investment arms. These regulators included the Federal Reserve, the Federal Deposit Insurance Corporation, and the Federal Housing Finance Board. Using the research presented below, it appears that all of these agencies had the regulatory goal to allow banks, thrifts, and bank holding companies to expand their array of allowable activities. This makes sense based off the relevant goals presented in Part 2. The Federal Reserve, particularly under Alan Greenspan, was concerned with bank profitability and deregulating the financial

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[141] Oral Argument, *Board of Governors of the FRS v. Investment Company Institute,* 450 U.S. 46, (1981), cited on Oyez p. 8
[142] *Board of Governors of the FRS v. Investment Company Institute,* 450 U.S. 46 (1981)
[143] *ibid*, at 78
[144] ibid, at 47

industry. The Federal Housing Finance Board was concerned with thrifts remaining chartered as thrifts and not commercial banks. Lastly, the Federal Deposit Insurance Corporation was trying to keep its insured institutions profitable in order to protect its insurance fund. These goals drove these agencies to respond to *Investment Company Institute* by using tools derived from the Court case to wither way at Glass-Steagall prohibitions.

At the same time these agencies were removing Glass-Steagall provisions, it appears that no agencies were overly concerned with trying to fight Glass-Steagall provisions. I could not find evidence of any agency taking major enforcement or rule-making actions to stop the gradual deregulation of Glass-Steagall that is outlined below. Because there was no regulatory agency trying to stop the gradual repeal of Glass-Steagall, it is possible that this allowed its repeal to be an extremely effective deregulatory trend.

a) Federal Reserve

The Federal Reserve made quick use of its new tool, “greatest deference,” which the Supreme Court bestowed on the agency. In November of 1981, the Fed permitted bank holding companies to use traveler’s checks, something that had previously not been explicitly permitted.[145] The Federal Reserve defended its ruling by arguing “the court said ‘the Board’s determination of what activities are closely related to banking is entitled to the greatest deference.’”[146] Though this was not a securities activity, it was the first time the Fed used its “greatest deference” to expand the activities banks could engage in. Three years later, the Federal Reserve again used its greatest deference to allow five new non-banking activities: issuing of money orders, commercial real estate equity financing, underwriting dealings in government obligations, foreign exchange advisory and transaction services, and future commission

[145] 46 FR 58065 (November 30, 1981)
[146] ibid

services.[147] In allowing these services, many of which involved securities transactions, the Board cited that it believes the benefits of these non-banking services outweigh the potential harms.[148] Further, in 1986, the Federal Reserve permitted Bankers Trust to sell commercial paper on behalf of its clients. This ruling was challenged and the case was brought to the District Court, which affirmed that the Federal Reserve was allowed to approve the matter because of its "greatest deference."[149]

The Federal Reserve Chairman at the time of these rulings was Paul Volcker. As chairman, Volcker came in at the height of stagflation. As banks and bank holding companies were struggling for profits, Volcker and his board appeared to take the tools bestowed to them by the Supreme Court and used them to help Bank Holding Companies expand their services to increase profitability. After *Investment Company Institute*, Volcker and the Federal Reserve used the tool of "greatest deference" that was given to them and pushed towards deregulation of the prohibitions between banking and securities activities.

After Volcker was replaced with Alan Greenspan, Greenspan continued to use his agency's greatest deference tool to deregulate Glass-Steagall provisions. In 1988, the Federal Reserve successfully argued to the Washington D.C. Circuit Court that it could allow banks to own 5% of their investment portfolio in "bank ineligible" securities such as private label securities, assets backed by consumer loans, and ineligible commercial paper.[150] The Court justified its decision by saying that the Board was granted greatest deference by the Supreme Court. That same year, the Fed issued another ruling that allowed the Fed to permit banks to

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[147] 49 FR 794 (January 5, 1984)
[148] ibid
[149] Securities Industry Association v. The Board of Governors of the FRS et al. 807 F.2d 1052 (DC Cir. 1986)
[150] Security Industry Association v. Board of Governors of FRS. 839 F.2d 47, 69 (2d Cir 1988).

engage in various types of debt and equity securities transactions. Again, the Court reasoned its ruling by citing the "greatest deference" that the Supreme Court afforded the Fed in its decisions.[151] From *Investment Company Institute* in 1981 through 1988, the Federal Reserve used the tool of "greatest deference" to permit commercial banks to engage in various kinds of complex security transactions.

b) Federal Deposit Insurance Corporation (FDIC)

The Supreme Court affirmed through *Investment Company Institute* that banks that were members of the Federal Reserve System could establish affiliates that advised investment funds. However, the question still remained as to whether non-Federal Reserve member banks could establish such advisory arms. In 1982, the FDIC further extended the ability to establish advisory affiliates to non-member banks that were insured by the FDIC. The FDIC justified this extension by arguing that the Supreme Court in *Investment Company Institute* affirmed that the section of Glass-Steagall that prohibits securities activities only applies to banks and not their affiliates. The FDIC reasoned that this affiliate protection from Glass-Steagall should apply to all banks, not just Federal Reserve member banks.[152] In 1984, the FDIC acknowledged in a final rule that there might be some inherent risk in allowing banks to engage in securities activities. However, the FDIC affirmed that the Supreme Court ruling makes it clear that it is legal for an affiliate of the bank to engage in securities activities.[153] In these cases, the FDIC is taking the protections that the Supreme Court afforded Federal Reserve member banks and it extended them to all federally insured banks as well.

c) Federal Housing Finance Board (FHFB)

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[151] Security Industry Association v. Board of Governors of FRS. 900 F.2d 360, 365 (2d Cir 1988).

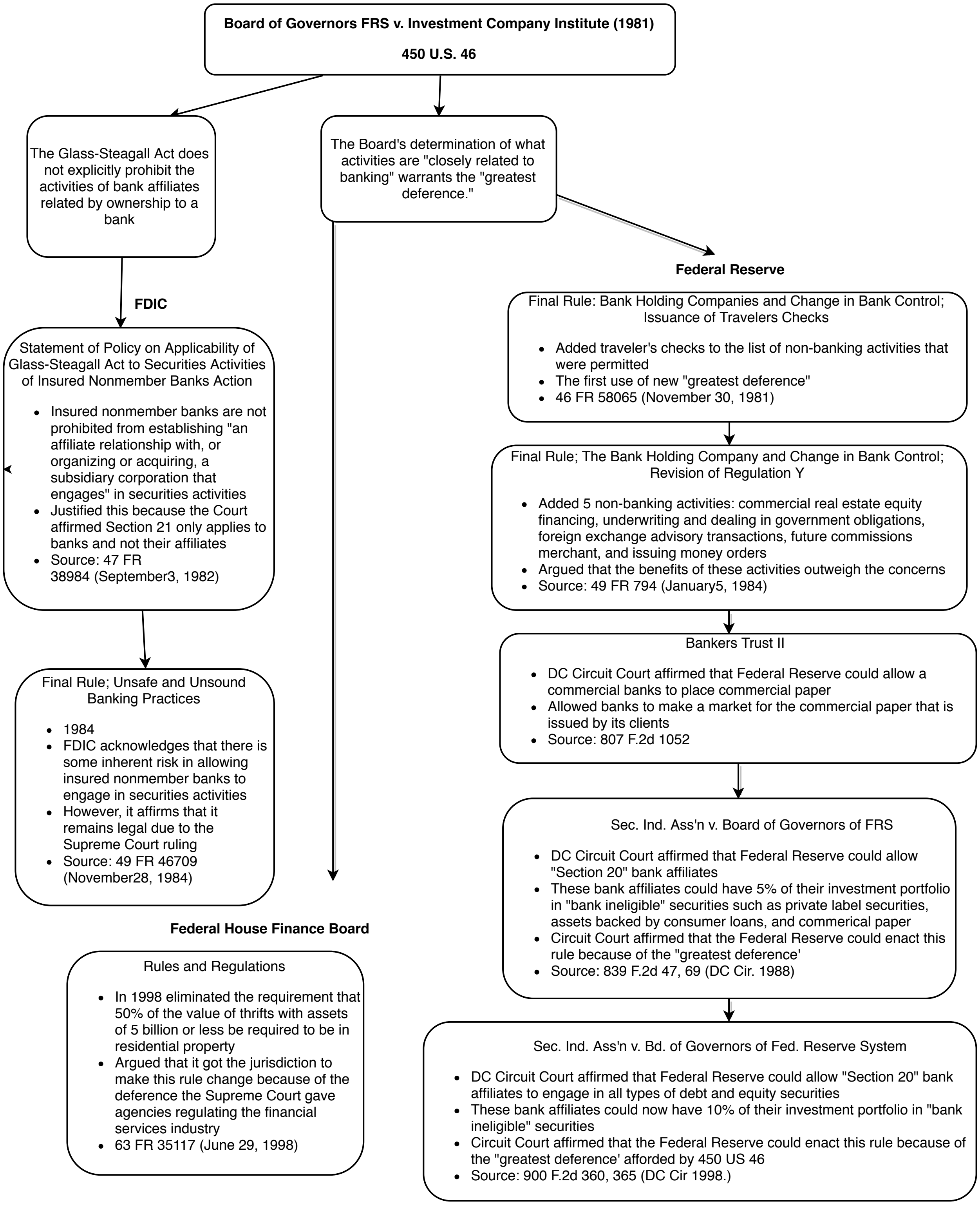
[152] 47 FR 38984 (September 3, 1982)

[153] 49 FR 46709 (November 28, 1984)

By 1998, the Federal Housing Finance Board was the new agency in charge of thrifts after the Savings and Loans Crisis of the 1980s caused the collapse of the Federal Home Loans Bank Board in 1990. Thrifts at this time were eager to diversify their portfolios outside of the housing market. In 1998, the FHFB issued a ruling that eliminated the requirement that 50% of the value of thrifts' assets had to be attributable to their residential portfolio.[154] The FHFB argued that it had the jurisdiction to enact this rule because of the deference that the Supreme Court provided to agencies in the financial services industry. Specifically, the FHFB cited *Investment Company Institute.*[155] In this ruling, the FHFB took the greatest deference that the Supreme Court bestowed onto the Federal Reserve, generalized it to all financial services agencies, and used it to further their agency's own deregulatory goals. Though this FHFB ruling did not involve a repeal of Glass-Steagall provisions, it was very important to the deregulation of the thrift industry. This ruling was particularly important because the deregulation of the thrift industry and its residential portfolio requirements was a major contributor to the savings and loans crisis of the 1980s.[156] By allowing thrifts to engage in even broader loans, the FHFB was inviting thrifts to take on the same kind of risky loans that brought their industry down in the 1980s.

[154] 63 FR 35117 (June 29, 1998)
[155] ibid, at 35124
[156] Pizzo, Stephen, et al. *Inside Job: the Looting of Americas Savings and Loans.* Harper Perennial, 1991. P 9-15

Figure 12: *Investment Company Institute (1981)* Impact



B. *Securities Industry Association v. Board of Governors FRS* (1984)

Shortly after *Investment Company Institute* gave broad discretion to the Federal Reserve to determine what non-banking activities commercial banks could engage in, the Federal Reserve approved BankAmerica Corporation to acquire Charles Schwab & Co. The Fed permitted a Bank Holding Company to purchase a discount brokerage firm for the first time since the enactment of Glass-Steagall.[157] Shortly after this purchase, Security Industry Association, a group of securities dealers, challenged the Board's approval of the acquisition. The Federal Reserve defended its decision by arguing that discount brokerage services were "closely related to banking" within the meaning of the Bank Holding Company Act, and therefore were a justified activity for a holding company to engage in. Though banks had not undertaken discount brokerage for half of a century, the Board argued that it was closely related to banking due to its "functional similarity" to current activities being undertaken in commercial bank trust departments.[158] Further, the Federal Reserve argued that the Glass-Steagall Act did not prohibit these activities because security brokerage does not involve the underwriting or promoting of securities.

The Supreme Court unanimously sided with the Federal Reserve, affirming that the Board does have the authority to approve BankAmerica to acquire a nonbanking affiliate engaged principally in retail securities brokerage. The Court said that brokerage activities were consistent with 4(C)(8) as closely related to banking.[159] The Court said that the determination was reasonable and affirmed that the Board had greatest deference in these decisions. One important nuance in the opinion was that the Court affirmed that it was okay for the Board to rely

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[157] *Securities Industry Association v. Board of Governors of the Fed. Reserve System,* 468 U.S. 207, Brief of the Securities Industry Association, 19-25 (1984)

[158] *Securities Industry Association v. Board of Governors of the Fed. Reserve System,* 468 U.S. 207, Brief for the Federal Respondent, 21-24 (1984)

[159] *Securities Industry Association v. Board of Governors of the Fed. Reserve System,* 468 U.S. 207, at 209 (1984)

on "its own banking expertise" to justify the approval of nonbanking activities.[160] The Court went as far to say that the Board could consider any reasonable basis for finding that an activity is "closely related" to banking. By giving this authority to the Board, the Supreme Court invited the Board to justify additional permitted nonbanking activities through their "expertise."

I. Regulatory Impact

a) Federal Reserve

Shortly after the case, the Federal Reserve issued a final rule expanding the list of nonbanking activities again. In this case, it expanded the list to include personal property appraisals, commodity trading and futures commission merchant advice, consumer financial counseling, tax preparation and planning, check guaranty services, operating a collection agency, and operating a credit bureau.[161] In this rule, the Federal Reserve asserted, "the courts have made it clear… that the Act grants the Broad discretion to consider any criteria which provide a reasonable basis for a finding that a particular nonbanking activity has close relationship to banking."[162] The Federal Reserve argued that it derived their authority to drastically expand the list of acceptable banking activities because of their "expertise."

In 1992, the Federal Reserve allowed commercial banks to act as agents for customers in the brokerage of shares of an investment company that the bank holding company advises.[163] In other words, a subsidiary of a bank holding company could sell to a customer a share of a company that was managed by that bank holding company. In effect, this act allowed bank holding companies to sell their own closed-end funds to their customers. This brought forward serious conflict of interest issues, as brokers of a bank holding company would be incentivized to

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[160] ibid, at 211
[161] 51 FR 39994 (November 4, 1986)
[162] ibid, at 206
[163] 57 FR 0387 (July 9, 1992)

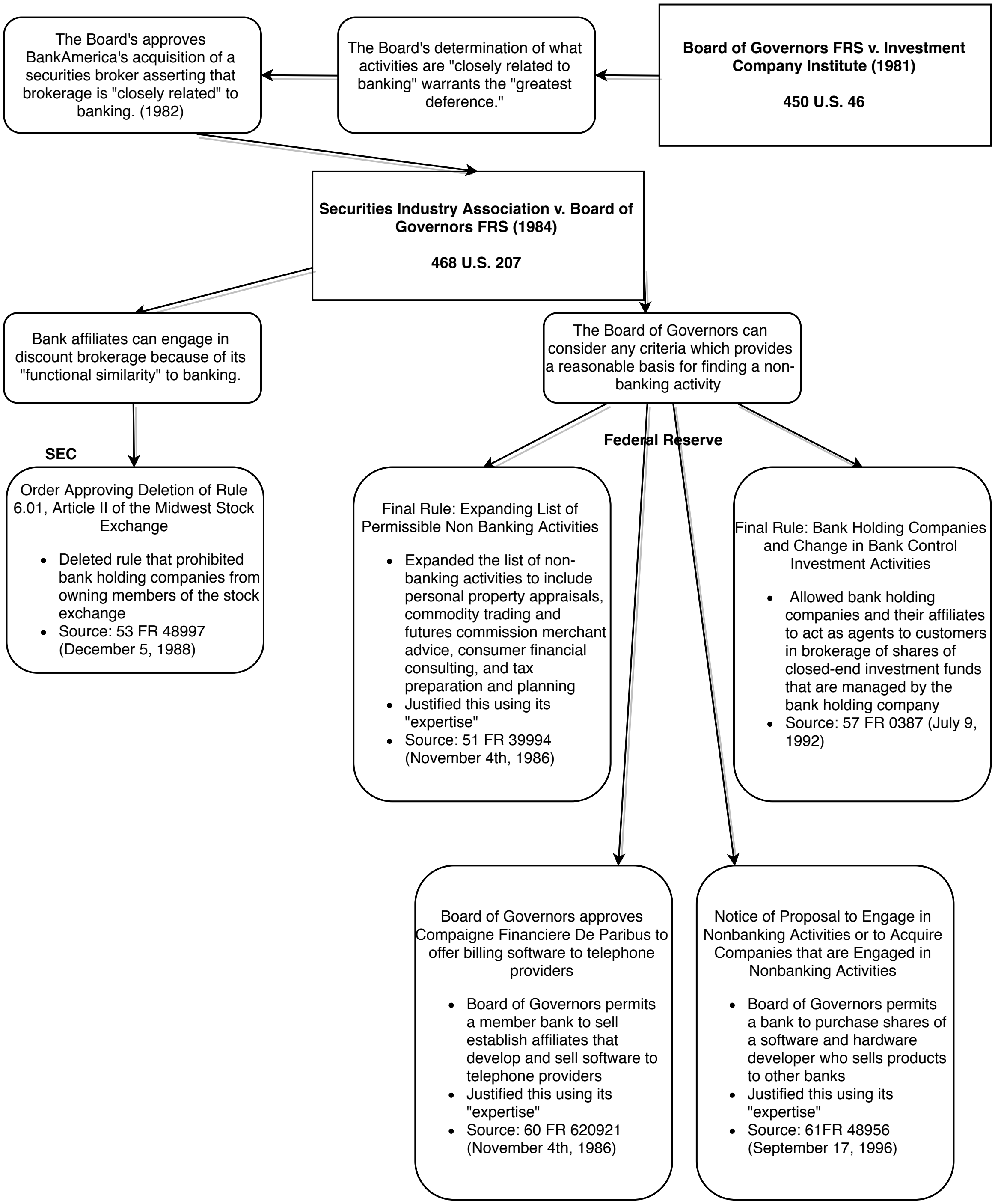
sell their clients shares of subsidiaries of their own company over shares of companies that could offer higher returns. This type of securities transaction would likely be in violation of the Glass-Steagall Act as it was written, and it encompassed the kind of conflicts of interest that the legislation attempted to curtail. However, the Federal Reserve justified their ruling by saying that the Supreme Court affirmed in *Security Industry Association* that banks can serve in brokerage functions.

b) Securities and Exchange Commission (SEC)

The SEC oversees the major United States stock exchanges. The SEC has a goal to promote more competition and lower prices in these stock exchanges. Thus, the SEC used the Supreme Court ruling to increase the allowable participants in their exchanges. In 1988, the SEC amended its oversight of the Midwest Stock Exchange (what is today the Chicago Stock Exchange) to allow affiliates of banks or bank holding companies to become Exchange members.[164] The Board of the SEC made this change as BankAmerica, Chase, and Continental Illinois each obtained ownership or was bought out by commission-registered brokers. The Board justified this by pointing to *Securities Industry Association's* ruling that brokerage was functionally similar to commercial banking. This extended *Securities Industry Association* further by allowing commercial banks to become integrated into the brokerage securities business. This case allowed commercial banks to enter into the exchanges that had brought commercial banks trouble in the buildup to the Great Depression. In this case, the SEC used the Court ruling that brokerage was functionally similar to banking in order to permit bank affiliates on the exchange and foster more competition in one of their prominent securities exchanges.

[164] 53 FR 48997 (December 5, 1988)

Figure 13: *Security Industry Association (1984)* Impact



C. Gramm-Leach Bliley Act

After years of agencies using *Security Industry Association* and *Investment Company Institute* to integrate commercial banking and securities activities, Congress officially repealed the Glass-Steagall Act through the Financial Services Modernization Act of 1999.[165] This Act is more popularly known as the Gramm-Leach-Bliley Act. The impact that these two cases had on the act can be seen through the Congressional Reports and hearings that led up to the Act.

Shortly after *Investment Company Institute,* many bank lobbyists appeared in front of Congress lobbying for a statutory repeal of Glass-Steagall by pointing to the Supreme Court decisions. Lobbyists pointed out that the Court had affirmed a "significantly less stringent standard" in allowing banks to participate in securities activities.[166] In 1983, the United States House held a series of hearings it later titled "Confusion in the Legal Framework of the American Financial System and Service Industry."[167] Chairman of the House Sub-Committee on Government Operations Doug Barnard opened the hearings with the following statement:

> "The subcommittee begins today a series of hearings on one of the most difficult and pressing issues facing the Congress – the growing confusion in the legal framework of the American financial system and service industry. We live increasingly in a world of financial hybrids, outside the traditional divisions of

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[165] Financial Services Modernization Act of 1999. Pub. L. 106-102. 133 Stat. 1338. 12 Nov 1999. *Congress.gov*

[166] United States Cong. House. Subcommittee of the Committee on Government Operations. *Structure and Regulation of Financial Firms and Holding Companies. Part 2.* September 18 and 24, 1986. 99th Congress. 2nd sess. Washington. (Statement of Donald Senterfitt, President, American Bankers Association)

[167] United States Cong. House. Subcommittee of the Committee on Government Operations. *Confusion in the Legal Framework of the American Financial System and Service Industry.* July 19, 20, and 21 1983. 98th Congress. 2nd first. Washington.

> banks, savings and loans, mutual savings banks, insurance companies, real estate concerns, brokerages, and so on."[168]

As regulators continued to use their "greatest deference" to blur the distinctions between banks and other financial services, Congress became increasingly worried about the confusion that was being fostered by both consumers and those within the industry. Lobbyists and regulators began to push the notion that the confusion that has arisen in the industry can be solved with a repeal of the Glass-Steagall Act. The General Counsel of the SEC noted in his hearing that a way to combat this confusion was an overall and unambiguous repeal of Glass-Steagall.[169] Regulators pushing the narrative that a way to address general confusion is a total repeal is particularly interesting because it was often the regulators who were fostering confusion through using their use of "greatest deference" to approve additional nonbanking activities.

Rather than considering that the confusion could be addressed by strengthening the distinction between banking and securities activities, lobbyists, bankers, and agencies continued to argue that the confusion should be addressed by completely removing the distinction between financial service organizations. In a House Report for the Financial Institution Equity Act of 1984, an unsuccessful bill that would have re-strengthened Glass-Steagall provisions, libertarian Ron Paul pointed to *Security Industry Association* to show that the lines between financial services were being blurred. Paul used this to successfully argue against strengthening regulations.[170] By allowing agencies to break down the barriers of the Glass-Steagall provisions, the Supreme Court put Congress in a position where officially repealing Glass-Steagall was a natural step.

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[168] Ibid, at 1
[169] ibid, at 202
[170] U.S. Congress, House of Representatives, Committee on Banking, Finance and Urban Affairs, Report 98-889, Financial Institutions Equity Act of 1984 (July 12, 1984)

By 1997, regulators continued to blur the lines of banking and securities activities through using “Greatest Deference” and “Expertise.” The House Subcommittee on Financial Institutions and Consumer Credit held a hearing in 1997 to discuss a bill, which would serve as a precursor to the Gramm-Leach-Bliley Act, to repeal Glass-Steagall.[171] In her opening statement of the hearings, Chairwomen Roukema reflected the era’s contemporary view of Glass-Steagall, “Clearly, it is time to reform the Glass-Steagall.”[172] Through the hearings it became clear that years of agencies using their deference to blur Glass-Steagall provisions had led to the sentiment reflected in the Chairwoman’s statement. Congresswoman Maloney told the rest of the Committee that the result of the OCC allowing certain securities activities is “confusion and guesswork where there should be clarity and certainty.”[173] A letter from the Securities and Exchange Commission prepared for the hearings commended the bill for dealing with the customer confusion that has been caused as a result of the integration of banking and securities transactions.[174]

The Supreme Court, although indirectly, did have an impact on the ultimate repeal of Glass-Steagall. As discussed in this section, the Supreme Court helped regulators use their “deference” to integrate banking and securities activates. These hearings show that Congress was concerned with the blurring of Glass-Steagall distinctions when they repealed the act. Thus, through providing regulators with tools like “greatest deference” and “expertise,” the Supreme Court helped foster the agency behavior that led to the ultimate repeal of Glass-Steagall restrictions on banking and investment banking.

[171] U.S. Congress, House of Representatives, Committee on Banking, Finance and Urban Affairs, Report 98-889, Financial Institutions Equity Act of 1984 (July 12, 1984)
[172] ibid, at 3
[173] ibid, at 9
[174] ibid, at 536

D. Repeal of Glass-Steagall Conclusion

The Supreme Court had a significant impact on the gradual breakdown and eventual repeal of the Glass-Steagall Act and the integration of banking and nonbanking activities. The Supreme Court gave regulators with goals to increase the profitability of commercial banks the tool of "greatest deference" and "expertise." These tools allowed the agencies to use their deference and expertise to make justifications for continuing to repeal Glass-Steagall provisions. By removing these provisions, regulators allowed commercial banks to engage in activities that were more profitable than traditional commercial bankin.. After the Supreme Court helped regulators to blur the line between commercial banking and other securities activities, lobbyists and lawmakers pressed forward with the ultimate statutory repeal of Glass-Steagall. In effect, the Supreme Court helped drive the deregulation of Glass-Steagall provisions until the entire act was ultimately repealed in 1999.

Conclusion

The Burger Court altered the course of banking regulation through providing regulatory tools and roadblocks to banking regulatory agencies. The Burger Court consistently provided agencies with goals to remove regulations on banks with the tools they need to do so. At the same time, the Supreme Court consistently provided regulatory roadblocks to agencies with goals to increase or maintain tight regulations on banks. Over time, this allowed for the deregulatory goals of some agencies to override the pro-regulatory goals of other agencies.

This trend could be seen through all three case studies presented in this thesis. Federal agencies with goals to reduce interest rate caps on bank loans were given the tool of federal preemption. This allowed federal regulators to overrule states with strict usury interest rate laws.

At the same time, this federal preemption served as a regulatory roadblock for state agencies with goals to protect their borrowers from high interest rates on their loans. Over time, the tool and roadblock of federal preemption led to the reduction and removal of most interest rate restrictions on bank loans. Thus, the Supreme Court helped drive banking regulation towards deregulated loan caps.

The case study on the geographic expansion of banking also encompassed the deregulatory goals of some agencies overriding the pro-regulatory goals of other agencies. By allowing federal regulators to define branching, the Supreme Court provided these regulators with a tool to achieve their goal of bank expansion. At the same time, by taking away the ability to define branching from the states, the Supreme Court roadblock state regulators who sought to limit bank expansion through strict branching laws.

Further, by weakening the efficacy of antitrust litigation tactics for challenging bank mergers, the Supreme Court roadblocked agencies with goals to restrict bank expansion. At the same time, this provided agencies with goals to increase bank expansion an easier path to do so, as these regulators could approve bank mergers and acquisitions without fear of costly antitrust challenges. Relatedly, by allowing banks and bank holding companies to circumvent state branching laws through mergers, acquisitions, and special arrangements, the Supreme Court roadblocked state agencies who wanted to limit bank expansion. Through consistently providing tools to bank regulators with goals to deregulate bank expansion restrictions, and consistently providing roadblocks to bank regulators with goals to maintain bank expansion restrictions, the Supreme Court helped facilitate the deregulation of restrictions on bank expansion.

Lastly, the Supreme Court allowed regulators to repeal Glass-Steagall provisions by providing the Fed with the tools of “Greatest Deference” and “Expertise” to use when determining what activities would be permitted by banks and bank holding companies. By providing these tools, the Supreme Court accelerated the regulator-induced integration of commercial banking and securities activities. Eventually, the confusion caused by this integration helped lead to the statutory repeal of the Glass-Steagall Act.

During the Burger Court era, there were many forces driving government agencies towards deregulation; a general ideological trend towards free markets, advanced lobbying by those in the industry, and financial innovations all surely played a role in government agencies deregulating banks. However, my research suggests that the Supreme Court at the very least accelerated deregulation by providing tools and roadblocks to differing agencies based on their goals. In particular, the geographic expansion of banks and the integration of banking and securities activities led banks to become much larger, much more integrated with each other and the broader financial system, and much riskier. As banks grew in size and scope, banks were able to take on more and more risks as the federal government continued to subside their risks through deposit insurance and too-big-to-fail policies.

As the Court accelerated agencies in their deregulation of the banking industry, often times no actor or agency ensured that the system remained structurally sound under deregulation.[175] For example, as the Court allowed regulators to permit commercial banks to engage in securities transactions, regulators did not adequately equip commercial banks with the capital requirements necessary to absorb the large losses that could come with risky securities deals.[176] By accelerating banking deregulation, the Supreme Court helped foster a risky and

[175] Wilmarth, Arthur E. “Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street.” *University of Cincinnati Law Review,* 81, p. 1333-1336, 18 Sept. 2013. *LexisNexis Academic.*
[176] ibid, at 1333

fragile banking environment leading up to the 2008 financial crisis. My thesis highlights the role that the Supreme played in these banking conditions.

Through this thesis, I have sought to prove the regulatory tool and roadblock theory of the judicial-agency relationship. This thesis proves that the regulatory tool and roadblock theory can be extended to banking regulatory agencies. Thus, this provides motivation for two future applications of my research. First, the regulatory tool and roadblock theory should be used to analyze current bank regulatory conditions. Through applying this framework to Roberts Court decisions and contemporary banking regulatory agencies, scholars should be able to predict more accurately the regulatory impact the current Court may have on future banking policies. This will allow scholars to understand the macro-regulatory impact that the Roberts Court may have on the banking system as a whole.

Second, the regulatory tool and roadblock theory should be tested in other regulatory policy areas outside of banking. Because of the differences between economic regulators and other regulators discussed in Part 2, it would make sense to begin this extension through other areas of economic and market regulation. If the findings in this thesis can be extended to the other areas of regulation, the regulatory tool and roadblock theory can lay the groundwork for a new understanding of the judicial-agency relationship.

Figure 14: The Impact of Tools and Roadblocks

Case Study	Tools	Roadblocks	Impact
Interest Rate Maximums	**Federal Preemption** for federal regulators with goals to increase bank profitability.	**Federal Preemption** for state regulators with goals to protect borrowers from usury.	Reduction and removal of interest rate restrictions on bank loans.
Geographic Expansion of Banking – Branching	**Defining Branching** for federal regulators with goals to increase bank expansion	**Cannot define branching** for state regulators with goals to restrict bank expansion.	Removal of state restrictions on bank expansion.
Geographic Expansion of Banking – Mergers and Acquisitions / Special Arrangements	**Less fear of potential competition doctrine, Section 1, or Section 7 antitrust challenges** for regulators with goals to promote bank expansion.	**Weakened litigation tools** for antitrust regulators with goals to protect market shares. **Weaken efficacy of state branching laws** for state regulators with goals to limit bank expansion.	Removal of state restrictions on bank expansion.
Repeal of Glass Steagall	**“Greatest Deference”** and **“Expertise”** for regulators with goals to remove Glass-Steagall provisions.	N/A	As no observed regulators fought back on the deregulation of Glass-Steagall, the prohibitory provisions of the act were gradually reduced.